# Financial History

The magazine of the Museum of American Finance

*Debt and Democracy: Forging a More Perfect Union*

*Who Paid to Defeat Hitler?*

*America on the Bargain Counter*

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# FINANCIAL HISTORY

THE MAGAZINE OF THE
MUSEUM OF AMERICAN FINANCE

*in association with
the Smithsonian Institution*

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MU$EUM OF AMERICAN FINANCE

**www.MoAF.org**


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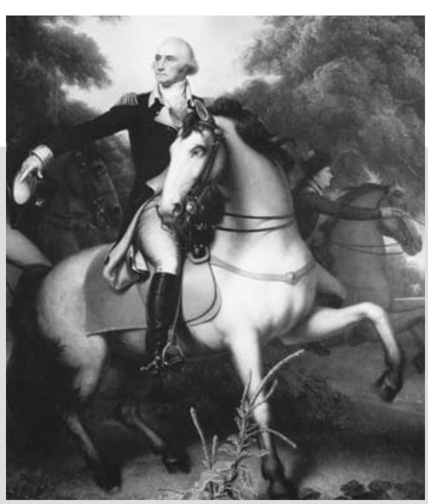
IN THIS ISSUE

# DEPARTMENTS



## ON THE COVER

"Washington Before Yorktown," by Rembrandt Peale, 1824–1825. The rider on the right is Alexander Hamilton. See related article, page 20.



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# Pulitzer Prize Winner, Nobel Laureate, Governor and Recent Secretary of the Treasury Speak at the Museum

## Message to Members

David J. Cowen | President and CEO

At our most recent Board meeting in November, I presented an update to the Trustees about all of the programs and projects that are currently underway at the Museum. The reaction was complete pride at not only the sheer volume, but also the quality of events and educational offerings. The fall session of the Museum Finance Academy concluded in November, with more than 85 high school students receiving certificates of completion. We have also secured funding for a special Girls Academy for Financial Education starting in early 2015. Our P-Credit continuing education program for New York City teachers will resume in the spring. We also have workshops planned with the New York City mentoring program in January, following on the heels of the Mathfest program held at the Museum in 2014 for 300 middle school students. And we now offer 19 different classroom experiences for groups of all ages.

Several high profile speakers came to the Museum in the fall, each attracting large audiences. Governor Cuomo was here in October to receive an award for improvements in New York's corporate tax structure. Tim Geithner spoke to a capacity crowd on the anniversary of the Crash of '29, and the Museum premiered a documentary film about the "Charging Bull" sculpture at Bowling Green Park, featuring remarks by artist Arturo Di Modica.

We also hosted seven Lunch and Learn events in the fall, including Pulitzer Prize-winning author Edward Larson, who has also contributed to this issue of our magazine (*see article, page 20*). Tony and Grammy Award-winning artist Lin-Manuel Miranda filmed at the Museum for a full day for his upcoming documentary on his new off Broadway show about Alexander Hamilton, opening in January. And for the fourth consecutive year, John Herzog ran the Wall Street Coin, Currency and Collectibles Show at the Museum. As we go to press, we look forward to welcoming renowned author, publisher and financial historian Jim Grant to speak on his recent book (*see article, page 13*).

In October, our chairman, Dick Sylla, and I were in Turin, Italy for the second annual meeting of the International Federation of Finance Museums (IFFM). Financial literacy is on the forefront of our discussions, and we are proud to represent our country. The next meeting will take place this fall in China, where there are more than 20 different finance museums.

We have several exciting programs planned for the spring, including a panel on bitcoin, as well as a presentation by Nobel Prize-winning economist Joseph Stiglitz. On March 10, we will also launch our new book, *Genealogy of American Finance*, which was co-authored by Dick Sylla and *Financial History* editorial board member Robert Wright. The book will be published by Columbia Business School Publishing and has been generously underwritten by Chuck Royce.

Lastly, I would like to welcome two new Board members, Greg Bauer of Moody's and Kevin Shine of Shine Financial Services, LLC. Just as we continue to expand our programming, we also continue to expand our Board, and we thank all of our Trustees for their service. $

Elsa Ruiz

Left to right: Museum Founder John Herzog, Museum President David Cowen, former Secretary of the Treasury Tim Geithner and Museum Trustee Charles Wait at the October 29 event.

**JAN 1 1862** The first federal income tax imposes a 3% tax on all incomes over $800.

**JAN 1 1981** The first 401(k) plan, designed by employee-benefits consultant Ted Benna to include pre-tax payroll deductions and company matching contributions, goes into effect for the 85 employees of the Johnson Cos. in Newtown, PA.

# Tim Geithner Speaks at Museum, Opens Hamilton Exhibit

Photos: Elsa Ruiz

Top: Representatives of the Alexander Hamilton Awareness Society (AHA) with Tim Geithner at the ceremonial opening of the "Alexander Hamilton: Indispensable Founder and Visionary" exhibit. Bottom: Tim Geithner in conversation with Charles Wait.

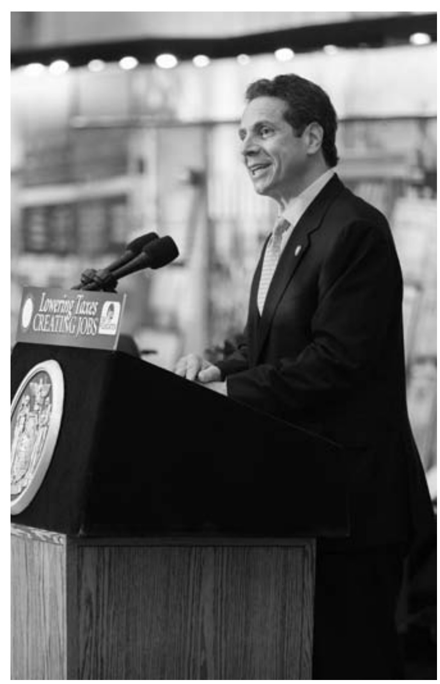
On October 29, more than 225 people attended a sold-out event at the Museum, as Tim Geithner spoke about his book, *Stress Test: Reflections on Financial Crises*, in a conversation with Charles Wait, former member of the Federal Reserve Bank of New York's Board of Directors and a Trustee of the Museum. The event, sponsored by Voya Financial, was appropriately held on the 85th anniversary of the Great Crash of 1929.

As President and CEO of the Federal Reserve Bank of New York between 2003 and 2009 and then Treasury Secretary for the duration of President Barack Obama's first term, Geithner shaped the American response to the global financial crisis. He was at the center of Fed policy as the crisis unfolded, and he was a principal architect of the Obama Administration's strategy to avert economic collapse and to reform the financial system.

Prior to the program, Geithner attended the formal opening of the "Alexander Hamilton: Indispensable Founder and Visionary" exhibit in the Museum's Hamilton Room. The exhibit was co-curated by Museum Founder John Herzog and Mariana Oller of the Alexander Hamilton Awareness Society (AHA). On view through January 2015, the exhibit commemorates the 225th anniversary of Hamilton's appointment as the nation's first Secretary of the Treasury. $

## Governor Cuomo Receives Tax Award at Museum

Governor Andrew Cuomo received the Tax Foundation's Outstanding Achievement in State Tax Reform Award at a press conference held at the Museum on October 16. The Museum's exhibitions served as a backdrop for the award ceremony, which coincided with the governor's announcement of the state's latest employment numbers.




Clockwise from top left: Members of the media attend the October 16 press conference; Governor Cuomo accepts a corporate tax award for New York State; Governor Cuomo meets the Museum's chairman, Richard Sylla, and president, David Cowen.

**JAN 30 2000** As the Internet bubble nears its peak, 17 dot com companies each spend $73,000 per second for network television ads — a total of nearly $38 million — during Super Bowl XXXIV.

**FEB 5 1637** "Tulipmania" hits its peak in the Netherlands, with the price of the rare Witte Croonen tulip bulb reaching 1,345 guilders per half pound, up 2506% in 33 days. Over the next five years, they lose an annual average of 76% of their value.

# Volunteer Spotlight: Carolyn Krouse

It is the mission of Museum volunteer Carolyn Krouse to let people know that New York doesn't have to be an unfriendly city. And based on feedback from guests and other members of the visitor services team, it is clear she is succeeding.

A high school English teacher-turned-author, Carolyn spent four years in Japan due to her husband's corporate relocation, so she is familiar with the challenges of being in a foreign land. The author of several non-fiction books, Carolyn's most successful publication is *A Guide to Food Buying in Japan*, which helps English-speaking residents of Japan purchase groceries in Japanese markets. This is a key reference for the target demographic, as the prices are considerably less expensive in the Japanese markets than in the country's western markets. Still in print, the book has sold more than 15,000 copies since its original publication in 1986.

Upon moving from Japan to Mahwah, New Jersey, in 1986, Carolyn began working with a local reference librarian, a position that she greatly enjoyed and hoped to continue when she moved to New York City in 2010. Unable to find a suitable volunteer position at a library in the city, she expanded her search to include museums.


However, many of the larger institutions were less flexible in their scheduling than she had hoped and did not seem to be a good fit because of her love of travel.

While taking a course at New York University, she was introduced to the Museum of American Finance on a class field trip. Struck by the beautiful building and having enjoyed the tour, she inquired about volunteer opportunities. In 2011, she began volunteering at the Museum's front desk on Tuesdays.

Carolyn said her favorite aspect of her volunteer work is that she gets to meet a variety of interesting people who come through the door, while working with an inclusive, friendly and accommodating visitor services staff.

"During the normal course of a week, I don't meet a lot of new people; but one day a week, I say hello to the world," she said.

When Japanese and French tourists visit the Museum, they are often pleasantly surprised to find an American at the front desk who speaks their language. And whenever she has the opportunity to talk to visitors, she asks where they are from. Because she is an avid traveler, she can often tell them she has visited their country and can share a story or two.

Carolyn and her husband take about three long trips of at least four weeks per year. Among her favorite travel destinations are Australia (where she recently spent a month) and Prague (where she travels every two years to see the Czech opera). She also enjoys opera in New York City, and she visits as many museums as she can, both in the United States and abroad. $

## MUSEUM OF AMERICAN FINANCE BENEFACTORS (2013–2014)

The Museum is most grateful for the financial support of these major donors to help advance our commitment to preserving, exhibiting and teaching the power and value of American finance.

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- Wells Fargo
- Voya Financial

► For information about the Museum's benefactor program, please contact Mindy S. Ross at 646-833-2755 or mross@moaf.org.

**FEB 8 1977** The Vanguard Group of Investment Companies eliminates all sales charges, becoming a no-load fund family.

**FEB 20 1795** Robert Morris creates the North American Land Company. Its prospectus guarantees it will pay dividends of at least 6% a year, but the stock crashes and lands Morris in debtors' prison.

## MU$EUM OF AMERICAN FINANCE

UPCOMING EVENTS

| | |
|---|---|
| **Jan 29** | Evening Lecture Series: "A Conversation with Albert Gallatin." Program followed by Q&A and reception. 5:30 – 7:00 p.m. |
| **Feb 11** | Evening Lecture Series: "Bitcoin and the Future of Payments Technology" panel discussion, featuring a conversation with Lawrence Summers and the launch of the book *The Age of Cryptocurrency,* by Paul Vigna and Michael Casey. Fireside chat and panel discussion followed by book signing and reception. 5:00 – 7:00 p.m. |
| **Feb 12** | Lunch and Learn Series: Bruce Smart on "People on US Bank Notes, 1861–1928: The Famous, the Familiar, the Forgotten." Talk followed by Q&A. 12:30 – 1:30 p.m. |
| **Feb 24** | Lunch and Learn Series: Mary Pilon on *The Monopolists*. Talk followed by Q&A, book signing and reception. 12:30 – 1:30 p.m. |
| **Mar 10** | Book Launch: Talk and reception to celebrate the release of the Museum's new book, *Genealogy of American Finance,* by Robert E. Wright and Richard Sylla (Columbia Business School Publishing, 2015). 5:30 – 7:00 p.m. |
| **Mar 18** | Evening Lecture Series: Panel discussion on *A Force for Good: How Enlightened Finance Can Restore Faith in Capitalism,* by John Taft, featuring financial luminaries. Panel followed by Q&A, book signing and reception. 5:30 – 7:00 p.m. |
| **Apr 15** | Exhibit Opening: Re-Launch of "Money: A History," featuring the Mark Shenkman Collection. |
| **Apr 21** | Evening Lecture Series: Joseph Stiglitz on *The Great Divide*. Talk followed by Q&A, book signing and reception. 5:30 – 7:00 p.m. |

***All events are held at the Museum (48 Wall Street, NYC) unless otherwise noted.***
***For more information or to register online, visit www.moaf.org/events.***

# Museum Premieres "Charging Bull" Documentary and Displays Replica Sculpture

On the evening of December 3, the Museum hosted the first showing of a new documentary film, "Lucky Balls," commemorating the 25th year that the "Charging Bull" sculpture by Arturo Di Modica has been at Bowling Green Park in New York City. Over the years, the sculpture has become one of the most popular attractions in Lower Manhattan and one of the most widely-recognized images around the world. The documentary will be entered in the Tribeca Film Festival next year, and eventually a wider distribution is anticipated.

The film screening drew some 200 people from the Museum membership and invited guests. Di Modica spoke at the event, as did the Polish producers of the documentary and the Museum's founder, John Herzog, who is featured in the film.

While "Charging Bull" has become well-known around the world, there are also smaller editions of the beautiful sculpture. The Museum was fortunate in locating one of these, a 42″ stainless steel model cast under Di Modica's direction. It is now on view in the grand entrance foyer of the Museum, graciously loaned by Gina Biancardi, the president of Casa Belvedere, a cultural organization on Staten Island. With this loan, the Museum is the first in the world to display Di Modica's work. His other works are on outdoor display in Poland, Russia, China and elsewhere. "Charging Bull" will be on view at the Museum through March 2015. **$**


The Museum's founder, John Herzog, with Gina Biancardi, president of Casa Belvedere.

**FEB 28 1827** America's first great growth industry is born, as 24 business leaders incorporate the Baltimore and Ohio Railway Co. to connect the "western frontier" with the eastern seaboard.

**MAR 3 1901** J.P. Morgan announces he is organizing the world's largest corporation by merging his Federal Steel conglomerate with Carnegie Co. The company is initially capitalized at $1.4 billion — the first billion-dollar company.

# The Drexel Burnham Lambert Archives

**By Linda Eichler**

Drexel Burnham Lambert was a prominent and very successful Wall Street investment bank which was forced into bankruptcy in February of 1990. It began as Burnham and Company, a small New York City retail brokerage firm founded in 1935 by I. W. Burnham II, a 1931 graduate of the Wharton School of the University of Pennsylvania. Burnham began his firm with $100, 000, of which $96,000 was borrowed from his grandfather, a founder of a Kentucky distillery.

The firm branched out into investment banking, and in 1973 it merged with Philadelphia-based Drexel Firestone, an ailing old line investment bank, which welcomed the merger with Burnham to form Drexel Burnham and Company. The name "Drexel Burnham" rather than "Burnham Drexel" was chosen because Drexel Firestone was known as a "major bracket" firm with the power to underwrite stocks and bonds, while Burnham and Co. was merely a "sub-major firm" with no such power. In 1976, Drexel Burnham merged with William D. Witter, the American arm of the Belgian company, Georges Bruxelles Lambert, and then incorporated as Drexel Burnham Lambert (DBL).

Great success followed, largely driven by DBL's dominance in the high yield bond market. Before the late 1970s, blue chip companies that had fallen on hard times had to issue high yield bonds (junk bonds), which often did not fare well in the future. But Michael R. Milken, a Wharton MBA who ran the California bond trading desk of DBL, discovered that new entrepreneurial companies with lower credit ratings — rated BB or lower — were found to have only a slightly higher rate of default than solid blue chip issues, but interest rates on these new bonds were higher than those of the blue chips. Therefore, a diversified bond portfolio made up of these new higher-risk companies would do well into the future.

In the past these new low-credit companies could only raise money by offering their stock rather than their bonds, but now DBL created a market for these first issue high yield bonds. DBL's share of this market peaked at 75% in 1983 and 1984. In the mid-1980s, DBL was ranked among Wall Street's top investment banks with employees numbering over 10, 000. In addition to high yield bonds financing new companies with low credit ratings, DBL's Mergers & Acquisitions Department used the bonds for financing leveraged buyouts and hostile takeovers.

The demise of Drexel Burnham Lambert began in 1986 with the government investigation of allegations that the firm had engaged in various illegal activities. DBL denied it had done anything wrong, but suits by the US Securities & Exchange Commission (SEC) and the threat of a RICO indictment by the government took their toll. Eventually DBL pleaded guilty to six felony counts and agreed to pay $650 million to settle with the SEC in April of 1989.

Later that month, DBL eliminated 5,000 jobs after closing three departments. The firm's securities business collapsed when the parent, Drexel Burnham Lambert, defaulted on $100 million in loans, and Wall Street firms then sharply cut their business dealings with the firm. DBL filed for protection from its creditors under Chapter 11 of the Federal Bankruptcy Code on February 13, 1990. Thousands of DBL employees were looking for new jobs, as Wall Street was stunned by the rapid decline of the company which had just recently announced it was seeking a partner because of a cash crunch.

In April of 1990, Milken pleaded guilty to securities and reporting violations, but not to racketeering or insider trading. He was sentenced to 10 years in prison and was fined $600,000. He was also barred from the securities industry. His sentence was reduced to two years, of which he served 22 months.

In 1992, the firm emerged from bankruptcy as a small investment bank with just 20 employees. It was called New Street Capital. In 1994, New Street Capital merged with Green Capital.

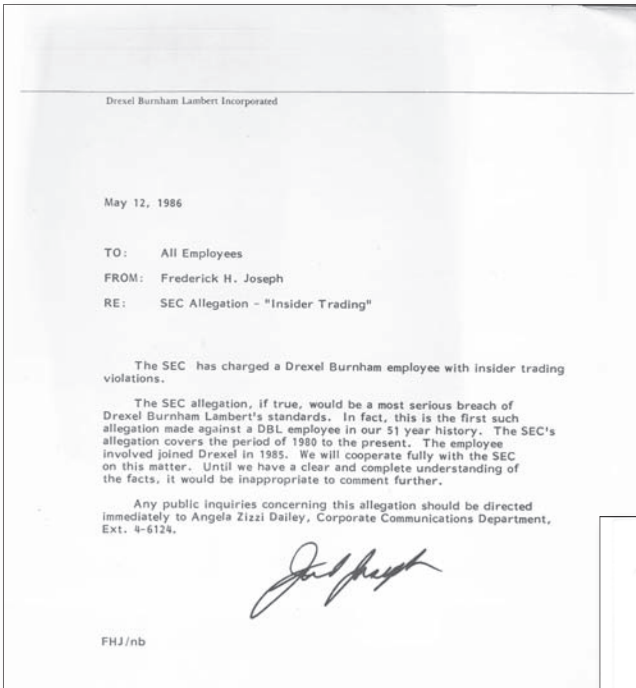
The Museum of American Finance was privileged to receive from John Z. Katz, a former Associate Director of Research at DBL, a gift of detailed historical documents of Drexel Burnham Lambert from its early beginnings through its bankruptcy and eventual reorganization. The material spans the years 1966 through 1996. It consists of internal memoranda and correspondence; financial statements including consolidated income statements; confidential and proprietary correspondence and documents; information about profit sharing; settlement with the U.S. SEC; Chapter 11 bankruptcy material; DBL Liquidating Trust material; research reports; company newsletters; promotional memorabilia; and journal and newspaper articles about the rise and fall of Drexel Burnham Lambert, etc.

A finding aid for this collection is currently being prepared to make the materials available to researchers by appointment. $

*Linda Eichler volunteers in the Museum's Library and Archives Department. She also gives an intro to using the Bloomberg terminal in the "Financial Markets" exhibit. Prior to joining the Museum, she had a 30-year career as a business reference librarian at the Lippincott Library of the Wharton School, University of Pennsylvania.*

**MAR 3 1933** President Franklin D. Roosevelt orders a nationwide bank holiday, during which banks must close to prevent a "run" on their deposits.

**MAR 14 1904** The US Supreme Court rules that J.P. Morgan's Northern Securities Co. holding company is stifling free competition — marking an end to the robber baron era.



Drexel Burnham Lambert Incorporated

May 12, 1986

TO: All Employees

FROM: Frederick H. Joseph

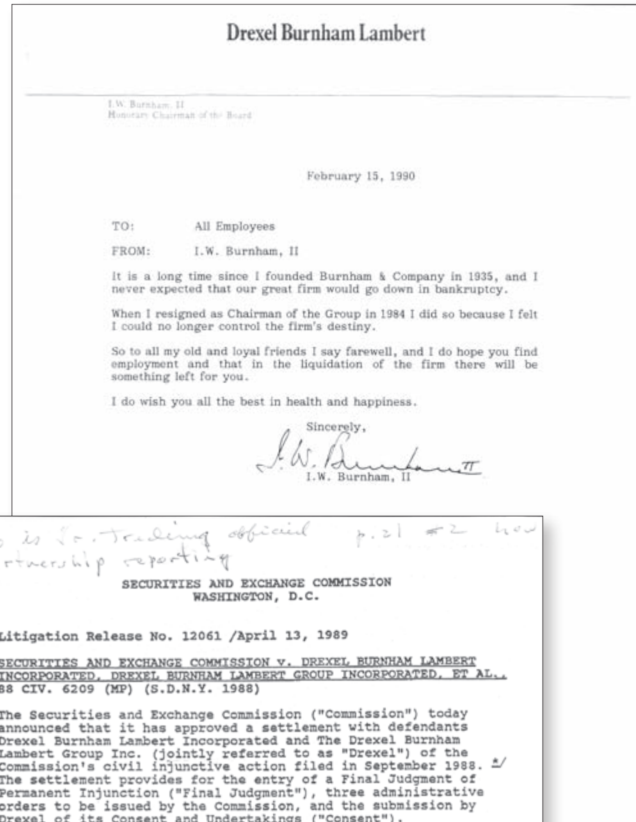
RE: SEC Allegation - "Insider Trading"

The SEC has charged a Drexel Burnham employee with insider trading violations.

The SEC allegation, if true, would be a most serious breach of Drexel Burnham Lambert's standards. In fact, this is the first such allegation made against a DBL employee in our 51 year history. The SEC's allegation covers the period of 1980 to the present. The employee involved joined Drexel in 1985. We will cooperate fully with the SEC on this matter. Until we have a clear and complete understanding of the facts, it would be inappropriate to comment further.

Any public inquiries concerning this allegation should be directed immediately to Angela Zizzi Dailey, Corporate Communications Department, Ext. 4-6124.

FHJ/nb



Drexel Burnham Lambert

I.W. Burnham, II
Honorary Chairman of the Board

February 15, 1990

TO: All Employees

FROM: I.W. Burnham, II

It is a long time since I founded Burnham & Company in 1935, and I never expected that our great firm would go down in bankruptcy.

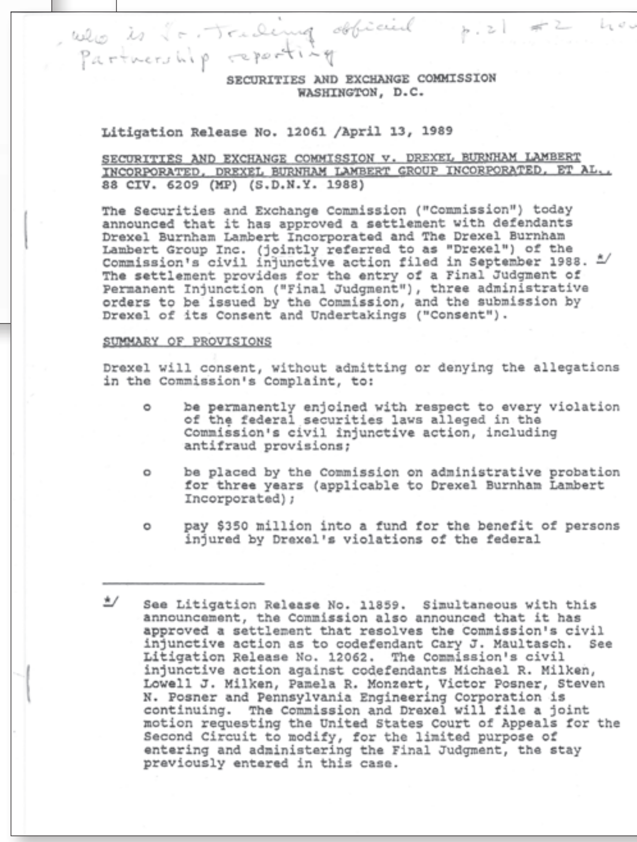
When I resigned as Chairman of the Group in 1984 I did so because I felt I could no longer control the firm's destiny.

So to all my old and loyal friends I say farewell, and I do hope you find employment and that in the liquidation of the firm there will be something left for you.

I do wish you all the best in health and happiness.

Sincerely,

I.W. Burnham, II



who is Sr. Trading official p.21 #2 how Partnership reporting

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.

**Litigation Release No. 12061 /April 13, 1989**

SECURITIES AND EXCHANGE COMMISSION v. DREXEL BURNHAM LAMBERT INCORPORATED, DREXEL BURNHAM LAMBERT GROUP INCORPORATED, ET AL., 88 CIV. 6209 (MP) (S.D.N.Y. 1988)

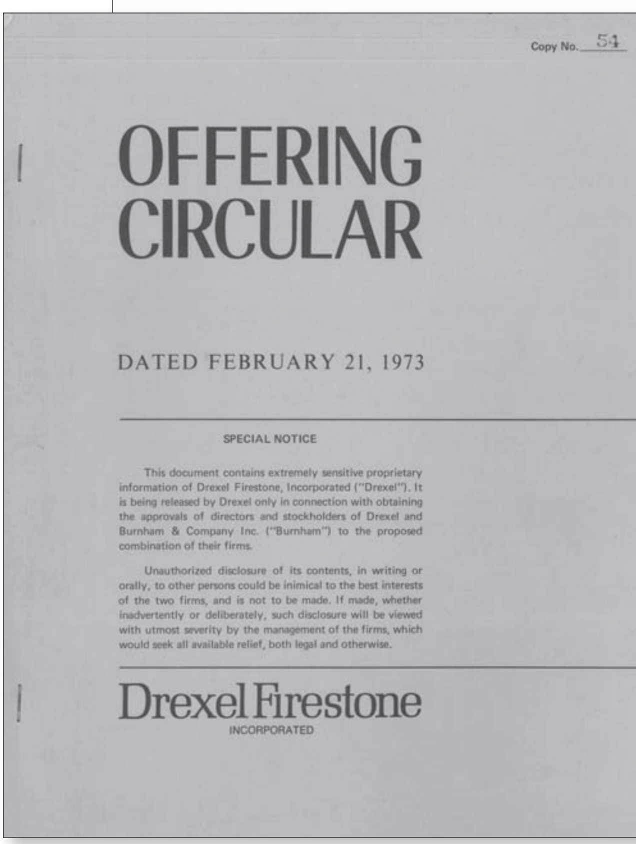
The Securities and Exchange Commission ("Commission") today announced that it has approved a settlement with defendants Drexel Burnham Lambert Incorporated and The Drexel Burnham Lambert Group Inc. (jointly referred to as "Drexel") of the Commission's civil injunctive action filed in September 1988. */ The settlement provides for the entry of a Final Judgment of Permanent Injunction ("Final Judgment"), three administrative orders to be issued by the Commission, and the submission by Drexel of its Consent and Undertakings ("Consent").

SUMMARY OF PROVISIONS

Drexel will consent, without admitting or denying the allegations in the Commission's Complaint, to:

- be permanently enjoined with respect to every violation of the federal securities laws alleged in the Commission's civil injunctive action, including antifraud provisions;
- be placed by the Commission on administrative probation for three years (applicable to Drexel Burnham Lambert Incorporated);
- pay $350 million into a fund for the benefit of persons injured by Drexel's violations of the federal

*/ See Litigation Release No. 11859. Simultaneous with this announcement, the Commission also announced that it has approved a settlement that resolves the Commission's civil injunctive action as to codefendant Cary J. Maultasch. See Litigation Release No. 12062. The Commission's civil injunctive action against codefendants Michael R. Milken, Lowell J. Milken, Pamela R. Monzert, Victor Posner, Steven N. Posner and Pennsylvania Engineering Corporation is continuing. The Commission and Drexel will file a joint motion requesting the United States Court of Appeals for the Second Circuit to modify, for the limited purpose of entering and administering the Final Judgment, the stay previously entered in this case.



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DATED FEBRUARY 21, 1973

SPECIAL NOTICE

This document contains extremely sensitive proprietary information of Drexel Firestone, Incorporated ("Drexel"). It is being released by Drexel only in connection with obtaining the approvals of directors and stockholders of Drexel and Burnham & Company Inc. ("Burnham") to the proposed combination of their firms.

Unauthorized disclosure of its contents, in writing or orally, to other persons could be inimical to the best interests of the two firms, and is not to be made. If made, whether inadvertently or deliberately, such disclosure will be viewed with utmost severity by the management of the firms, which would seek all available relief, both legal and otherwise.

Drexel Firestone
INCORPORATED

Clockwise from top left: Internal memo informing employees that a Drexel employee has been accused of insider trading, 1986; Internal memo from founder I.W. Burnham, II, bidding farewell to employees due to the firm's bankruptcy, 1990; Litigation document regarding the SEC case against DBL, 1989; Drexel Firestone offering circular, 1973.

**MAR 21 1868** The prospectus for the earliest known mutual fund is published in London, as the Foreign and Colonial Government Trust offers its shares to the public for 85 pounds sterling.

**MAR 29 1999** The Dow Jones Industrial Average closes above 10,000 for the first time, as it finishes the day at 10006.78.

# "Big John" Rides the Rails

By Brian Grinder and Dan Cooper

*Ev'ry mornin' at the mine you could see him arrive*
*He stood six foot six and weighed two forty five*
*Kinda broad at the shoulder and narrow at the hip*
*And everybody knew, ya didn't give no lip to Big John*

— Lyrics to "Big Bad John"

Burlington Northern Santa Fe train hauling "Big John" hopper cars towards Kansas City.

© Mark Reinstein/Corbis

The Southern Railway Corporation's "Big John" grain hopper car, like the hero of the ballad "Big Bad John" after which it was named, was enormous. Small 40-foot, weevil-infested box cars had been used to haul grain before Big John was introduced in 1961. Railroads hauled very little grain at the time because it was inefficient to do so. The process of loading and unloading box cars was labor intensive and inefficient. Furthermore, box cars tended to leak grain along the tracks, much to the delight of vermin along the way. The disadvantages and the expense of using box cars meant that most grain was transported by truck.

The Big John, in contrast to the lowly box car, was an innovative marvel. It loaded quickly from the top using grain spouts and unloaded just as quickly through the four hoppers at the bottom of each car. The lightweight, rust-proof aluminum design of the cars meant that they were, for all intents and purposes, maintenance free. Moreover, Big John could carry twice as much grain as a box car. The higher capacity and increased efficiency of the new car meant that Southern could slash its rates by two-thirds, win business from its competitors in the trucking and barge industries, and still realize significant profits.

In modern financial parlance, this was a positive net present value project that would clearly increase the value of the company; it was a no-brainer. D.W. Brosnan, president of Southern Railway, invested $12.5 million and ordered 500 of the new cars, but there was a big problem.

Implementing the new lower rates required the approval of the Interstate Commerce Commission (ICC). The ICC was established in the late 19th century to monitor railroads and prevent them from establishing a transportation monopoly. The Transportation Act of 1920 gave the ICC authority to establish minimum rates for interstate shipping in order to prevent ruinous competition among the railroads and to protect the trucking industry from unfair competition. Brosnan applied to the ICC for permission to publish the lower rates, but he was denied.

The ICC justified its decision to suspend the new rates by claiming that the lower rates would simply allow Southern to put competitors out of business and then raise its rates again. According to railroad historian Richard Saunders, Jr., "In 1961, the ICC denied the Big John rates saying, in effect, that the public should pay more for food so as not to hurt inefficient carriers."

Brosnan was even more pointed in his criticism of the ICC. In 1962, he testified before the House Commerce Committee:

> That kind of thinking makes about as much sense as telling a farmer that he can't drive his tractor faster than a mule can walk or have it pull more than a mule can pull just because some people still use mules. If the ICC prevails in its short-sighted and progress-killing tactics, the South will lose a great opportunity for growth, and every farmer and consumer in the South will be hurt.

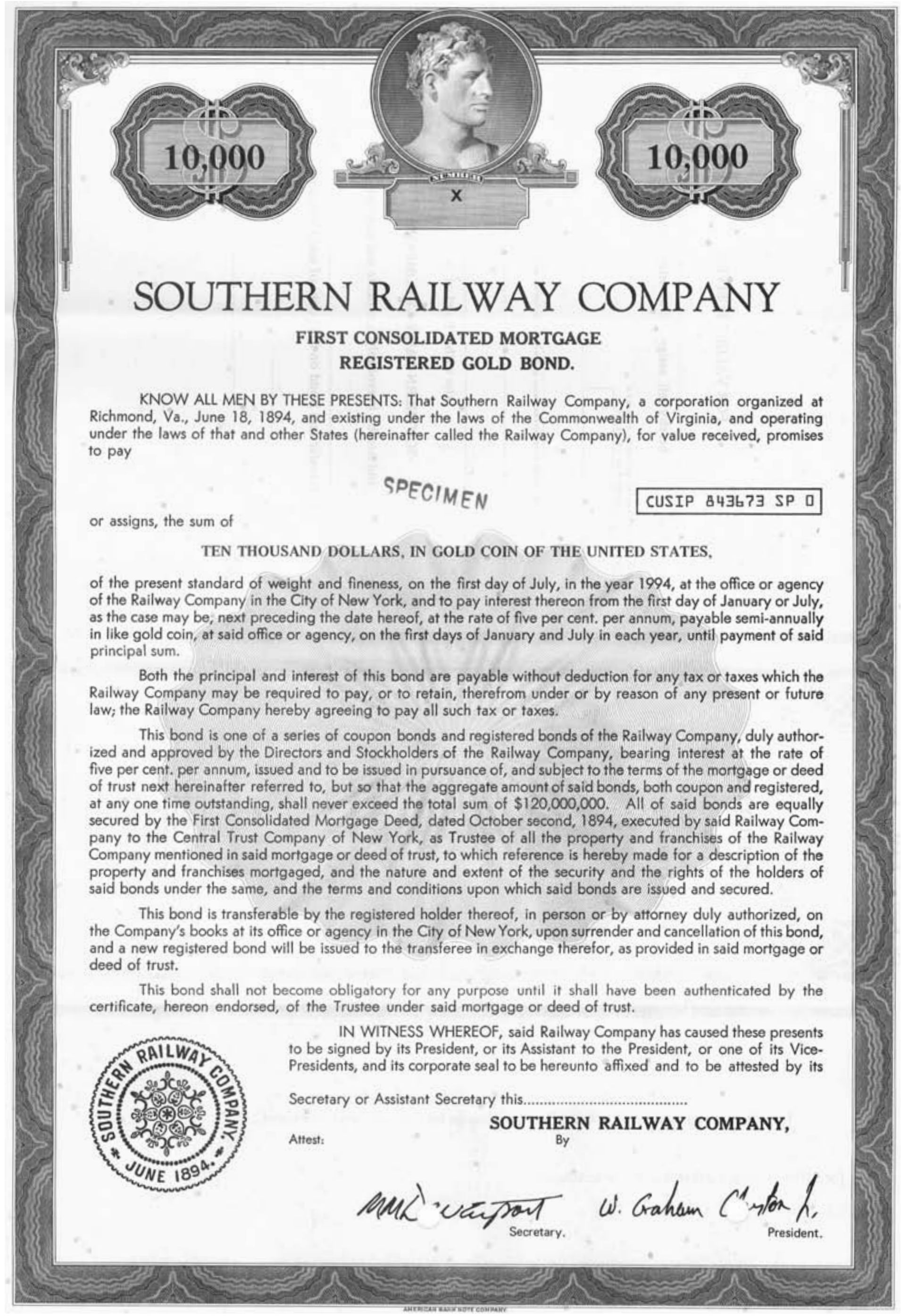
Brosnan responded to the ICC decision to suspend the lower rates by purchasing 200 more Big Johns. He declared war not only on the ICC, but also on other railroads that couldn't afford the newer larger cars, and on the Tennessee Valley Authority, which opposed the lower rates because they would reduce the use of barges for hauling grain to the South through its system of locks and dams. To Brosnan, the Big John wasn't just about lower rates; it was a stepping stone to transforming railroads into a growth industry. For this to happen, the ICC needed to be stripped of its ability to impose rates because it not only hurt the ability of railroads to operate efficiently, it also hurt the economy, especially the economy of the South, which was

forced to pay exorbitant rates to ship grain.

Brosnan's larger plan for the South was nothing less than a revolution in agriculture. The South did not produce much grain, which meant that cattle raised in the South had to be shipped to the Midwest where they would be grain fed and fattened for slaughter, then returned to the South in the form of finished meat products such as hamburger, steaks and roasts. Brosnan biographer Charles O. Morgret describes Brosnan's plan as "the essence of simplicity and logic. Instead of taking the cattle to the grain, he would bring the grain to the cattle."

The resulting increase in jobs and tax revenue along with lower beef prices would be a boon to the South's economy. His battle plan against the ICC was two-pronged: (1) effect change through legislation and (2) use the court system to force the ICC to change its position. The former approach offered some hope when John F. Kennedy was elected President. Although Brosnan despised Kennedy, the new administration supported reducing transportation regulations in favor of market competition. Brosnan hoped that this enlightened attitude would lead to legislation that would allow railroads to operate freely without government interference in rate setting. This hope proved elusive and came to an end when Kennedy was assassinated. The latter approach would ultimately bear fruit, but not without years of struggle and frustration. In the meantime, Brosnan had a large number of Big Johns sitting idle that needed to be put to work.

Since the ICC controlled rates for interstate — but not intrastate — commerce, Southern was able to offer the new lower rates to farmers in southern Georgia who shipped their corn to the poultry producing region of northern Georgia. These farmers, who were experiencing a bumper corn crop in 1961, jumped at the chance to ship at lower rates. Southern shipped millions of pounds of southern Georgia corn to northern Georgia at substantial savings. Ironically, Southern was also able to offer the lower rates to the Department of Agriculture whose various post-war programs had left it with a great deal of surplus grain. The grain was sold at rock bottom prices to poultry and livestock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SOUTHERN RAILWAY COMPANY

FIRST CONSOLIDATED MORTGAGE
REGISTERED GOLD BOND.

KNOW ALL MEN BY THESE PRESENTS: That Southern Railway Company, a corporation organized at Richmond, Va., June 18, 1894, and existing under the laws of the Commonwealth of Virginia, and operating under the laws of that and other States (hereinafter called the Railway Company), for value received, promises to pay

SPECIMEN

CUSIP 843673 SP 0

or assigns, the sum of

TEN THOUSAND DOLLARS, IN GOLD COIN OF THE UNITED STATES,

of the present standard of weight and fineness, on the first day of July, in the year 1994, at the office or agency of the Railway Company in the City of New York, and to pay interest thereon from the first day of January or July, as the case may be, next preceding the date hereof, at the rate of five per cent. per annum, payable semi-annually in like gold coin, at said office or agency, on the first days of January and July in each year, until payment of said principal sum.

Both the principal and interest of this bond are payable without deduction for any tax or taxes which the Railway Company may be required to pay, or to retain, therefrom under or by reason of any present or future law; the Railway Company hereby agreeing to pay all such tax or taxes.

This bond is one of a series of coupon bonds and registered bonds of the Railway Company, duly authorized and approved by the Directors and Stockholders of the Railway Company, bearing interest at the rate of five per cent. per annum, issued and to be issued in pursuance of, and subject to the terms of the mortgage or deed of trust next hereinafter referred to, but so that the aggregate amount of said bonds, both coupon and registered, at any one time outstanding, shall never exceed the total sum of $120,000,000. All of said bonds are equally secured by the First Consolidated Mortgage Deed, dated October second, 1894, executed by said Railway Company to the Central Trust Company of New York, as Trustee of all the property and franchises of the Railway Company mentioned in said mortgage or deed of trust, to which reference is hereby made for a description of the property and franchises mortgaged, and the nature and extent of the security and the rights of the holders of said bonds under the same, and the terms and conditions upon which said bonds are issued and secured.

This bond is transferable by the registered holder thereof, in person or by attorney duly authorized, on the Company's books at its office or agency in the City of New York, upon surrender and cancellation of this bond, and a new registered bond will be issued to the transferee in exchange therefor, as provided in said mortgage or deed of trust.

This bond shall not become obligatory for any purpose until it shall have been authenticated by the certificate, hereon endorsed, of the Trustee under said mortgage or deed of trust.

IN WITNESS WHEREOF, said Railway Company has caused these presents to be signed by its President, or its Assistant to the President, or one of its Vice-Presidents, and its corporate seal to be hereunto affixed and to be attested by its Secretary or Assistant Secretary this........................................

SOUTHERN RAILWAY COMPANY,
By

SOUTHERN RAILWAY COMPANY. JUNE 1894.

Attest:

W. Graham Claytor Jr.

Secretary. President.

Specimen gold bond certificate from the Southern Railroad Company.

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producers in the South and hauled in Big John grain cars for almost two years while Brosnan fought for the right to offer lower rates to commercial shippers.

In the meantime, Southern's rate case slowly wended its way through the court system and was eventually heard by the Supreme Court. After three rounds of deliberations, the Court finally decided in favor of the lower rates in early 1965. President Lyndon B. Johnson lauded the decision, noting it would save consumers \$30–\$40 million annually on food.

Southern Railway under the Brosnon's

leadership had won a decisive victory, and grain began to flow into the South. By the 1990s, Southern Railway alone was, according to Morgret, "moving nearly eight million tons of grain a year into the Southeast, 10 times the amount handled in 1960."

While southern cattle ranchers were slow to embrace the reality of lower grain prices, the poultry industry in the South grew rapidly after the introduction of lower rail rates for grain. Saunders contends that lower grain prices led to a significant change in America's diet because chicken, which had been relatively expensive, became much more affordable with the increase in poultry production.

In 1980, Brosnan was inducted into the Georgia Transportation Hall of Fame. At the induction ceremony, it was noted that poultry production was Georgia's largest agribusiness in 1978. A representative of one of Georgia's leading poultry producers claimed, "Had it not been for Mr. Brosnan's Big John capacity and greatly reduced freight rates, the massive southeastern broiler industry of today would still be a relatively small industry." Brosnan's battle with the ICC had much broader implications for railroads. Saunders wrote:

> Many believe it was the sheer stupidity of the ICC's vendetta against Big John that set in motion the bipartisan move to deregulate transportation rates that would culminate in the Staggers Act, signed by Jimmy Carter in 1980. This in turn made the ICC superfluous and led to its abolition in a bill signed by Bill Clinton in 1995.

Railroads were now free to innovate, set rates and manage their own affairs with much less government interference. $

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# AMERICA *on the* BARGAIN COUNTER

**By James Grant**

Cartoon from the Crash of 1921: "It's All Going Out."

By the *Wall Street Journal's* telling, it was no coincidence that so many titans of business and finance took to making public professions of optimism starting in the middle of September 1921. "It is known," the paper reported on September 19, less than a month after the Dow Jones industrials had put in their low, "that this change in attitude followed conferences between prominent bankers and men of high standing in finance." And what had these great men decided? "It was agreed that bottom for good securities, prices for commodities and business had about been reached, and that the situation warranted the spreading of optimistic propaganda."

The unsigned *Journal* dispatch imputed mighty powers to the unnamed financiers. It was they who were behind the recent strength in stock and bond prices, the story said. Nor had they had invested to scalp a few quick dollars of profit, as the professional traders on the floor of the New York Stock Exchange were wont to do. They rather bought for the long term because securities were cheap and because the country was on the upswing. Thus, "the stock market passed the control of professionals to what Wall Street terms 'big constructive interests.'"

Stocks were commandingly cheap, the *Journal*'s capitalist informants concluded. "Scores" of companies were valued in the market at less than their working capital — as if the business itself, apart from the net cash, was worthless. The shares of "large numbers" of industrial companies were selling at "one-third of their respective intrinsic values."

It was just as they said — America was on the bargain counter. The lyricist of the 1921 hit "Ain't We Got Fun?" had famously written, "the rich get richer." A more accurate, if less singable, formulation would have been, "the liquid and financially flexible rich get richer." The depression had driven the over-encumbered rich, like Billy Durant, founder and

president of General Motors, into the swelling ranks of the formerly rich. But for any with cash to invest, the opportunities in 1921 were boundless.

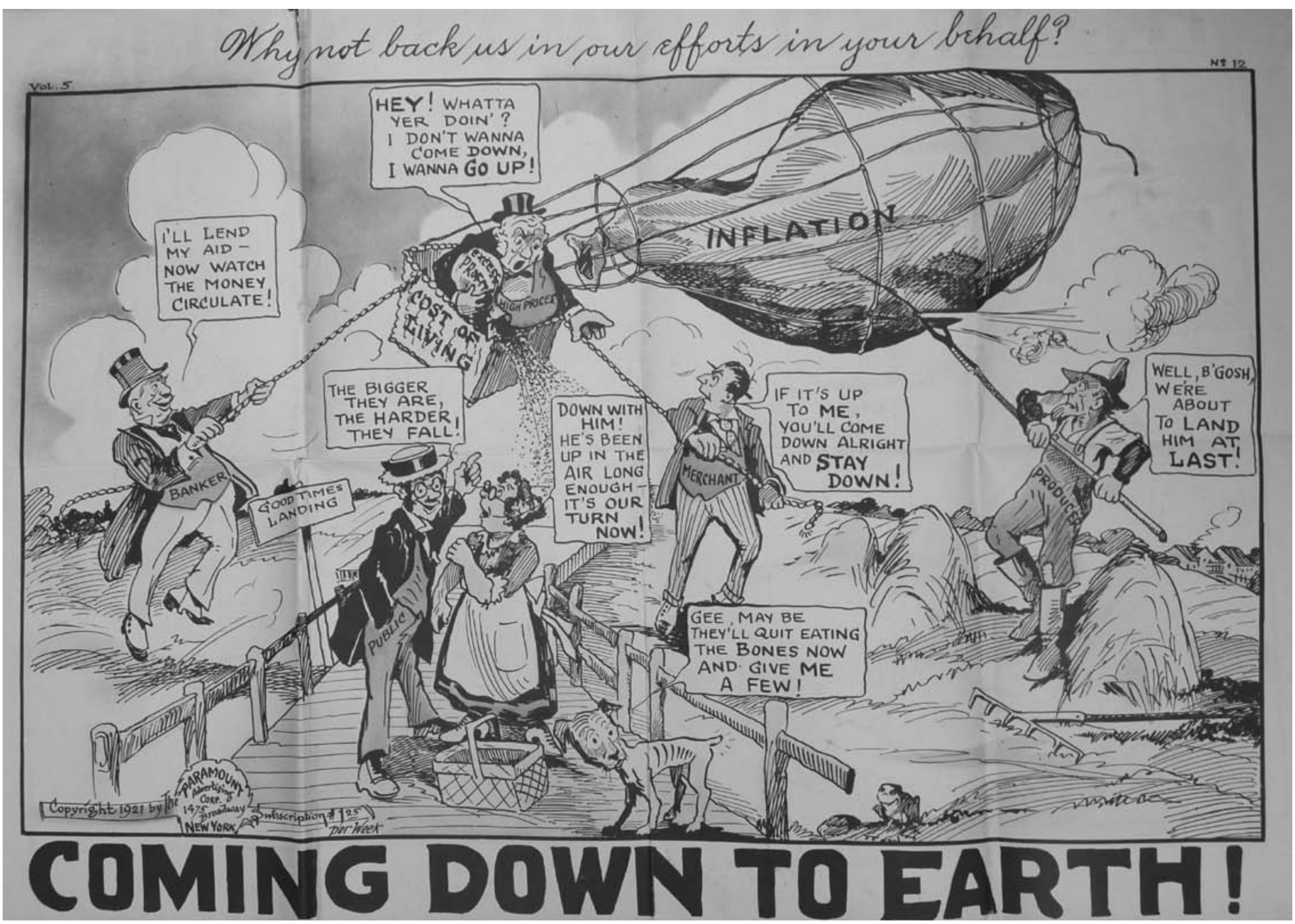
Thus, at the August 24 low in the Dow, General Motors changed hands at 9½. The company was on its way to showing a 1921 loss of $38.7 million, compared to a 1920 profit of $37.9 million and to selling just 215,000 cars, trucks and tractors, down from 387,000 in 1920. Management was in the process of writing down $55.9 million of inventory (from a 1920 starting point of $164.7 million) and of eliminating $33.1 million of short-term indebtedness.

The dividend, too, was on its way out. Liquidation had been the order of the day in 1921, the president, Pierre S. du Pont, reminded the stockholders early in 1922. But that chapter in the company's history was closed. "The year 1922 opens with inventory accounts reduced to current basis and old commitments provided for or adjusted. The opening months of the year show substantial increase in demand and sales, not only with respect to corresponding months of 1921, when business was nearly at a standstill, but also as to several divisions even in comparison with the record year 1920."

In the depths of the slump, some had speculated the automobile market was "saturated," that the Ford Motor Company itself was broke and that the best days of the evidently now mature industry were behind it. Roaring sales in 1922 hushed that discouraging talk. By late March, Ford was finding work enough to keep its employees busy for five days a week instead of the depression-shortened three. By late in April, there were reports of a developing labor shortage in Detroit. At least one automobile supplier, Michigan Copper & Brass Co., was recalling its salesmen from the road; as it was that company had more business than it could handle.

November 16 brought the cheering news that GM would resume paying a dividend. It was clear that the directors had not forgotten the company's near-death experience over the preceding year. They would authorize a payout of 50 cents a share just this once and defer a decision on a permanent rate of distribution. In 1920, the company had produced an average of 31,867 cars a month with an investment in inventory equal to about $5,548 per car; in 1922, it was producing an average of 45,000 cars a month with an investment in inventory of only $2,530 per car. "In other respects," the communiqué concluded, "the corporation has materially fortified its position and the outlook for the year 1923 is considered entirely satisfactory."

More than "entirely satisfactory," in fact, the results proved to be. At a price of 9½, at the depression lows of 1921, GM shares were valued at just 4.3 times 1922 earnings and 3.6 times 1923 earnings — that is, at what those earnings would prove to be (only a clairvoyant, and an optimistic clairvoyant at that, could

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Cartoon from the Crash of 1921: "Coming Down to Earth."

have predicted it in August 1921). At 14⅞, the closing price on the day of the dividend announcement, the stock was valued at 6.8 times 1922 earnings and 5.6 times earnings for 1923.

As General Motors prospered, so did the fortunes of GM's largest shareholder, Du Pont. In cars and trucks, the one-time leading outfitter of the ordnance departments of the Allied armies had found a business steadier and faster growing even than human conflict. Of the 20 million GM shares outstanding in 1922, Du Pont owned 7.4 million.

In that year, a gifted young investor took the trouble to compare the value of this single du Pont holding with the overall quoted value of Du Pont shares. The arithmetic revealed an anomaly. Just about all of the quoted Du Pont value was attributable to the value of the GM stock, and none to Du Pont's own non-automotive earnings and assets.

So the investor — Benjamin Graham, who is widely regarded today as the father of modern American security analysis — bought Du Pont while simultaneously selling GM. In Wall Street parlance, Graham performed a relatively riskless arbitrage operation, correctly reasoning that du Pont would sooner or later appreciate relative to GM. (The first thing he did upon founding Graham Corporation in the early 1920s, Graham relates, "was to buy some shares of Du Pont and to sell seven times as many shares of General Motors short against it. …So Du Pont was greatly undervalued by comparison with the market price of General Motors; in due course a goodly spread appeared in our favor, and I undid the operation at the projected profit.")

Then, again, like so many other stocks at the bottom of the market, Du Pont was cheap on its face, without reference to recondite techniques of valuation. Closely held, the shares rarely traded in 1921; at the 1922 low price of 105, they were valued at 6.3 times 1922 earnings and four times 1923 earnings (as those earnings were subsequently recorded).

On August 24, 1921, the low point of the Dow, many stock prices translated into multiples on 1923 earnings of less than five times. That held true of the steel companies, but also of the kind of consumer product companies that had enjoyed a relatively prosperous depression. Thus, Coca-Cola, at $19 a share — 500,000 shares were outstanding, providing a stock-market capitalization of all of $9.5 million — was valued at what would prove 1.7 times 1922 earnings and 2.5 times 1923 earnings; the shares provided a dividend yield of 5.26%.

Gillette Safety Razor Company, which was selling as many razors and blades in 1921 as it had in 1920, was quoted at a little more than five times forward earnings and yielded 9.23%.

Radio Corporation of America (RCA), not yet revealed as one of the great growth stocks of the 1920s, could be purchased in the market for about as much as the company earned in 1923: $1.50 a share.

As a matter of course on Wall Street, bargains go begging at the bottom of the market. In August 1921, stock prices had been sliding for almost two years. At such junctures, the memory of losing money is usually more vivid than the imagined prospect of making it.

It did not take much imagination to recognize the value of F.W. Woolworth Company, the five-and-dime chain merchandiser that was finishing its 10th year as a fused corporate unit. Frank W. Woolworth himself, founder and builder of the gothic corporate headquarters tower at 233 Broadway in Lower Manhattan, had died in 1919, but his successors had distinguished themselves in the depression. They had stopped buying any but essential merchandise after the break in wholesale prices in June 1920, while the customers, happily, had kept right on buying. Now 1921 sales were on track to surpass the total for 1920.

While other chain stores had raised prices, Woolworth hewed to the letter of its five-and-dime appellation (15 cents was the top ticket west of the Mississippi). And how was this exemplar of deflation-era merchandising — about to close its year without bank debt and with no mispriced inventory — valued in the stock market on August 24, 1921? At a price of $105 a share, or 3.7 times imminent 1922 earnings and 3.3 times what would turn out to be 1923 earnings. The stock yielded 7.62%.

Ultra-low equity valuations naturally favored the "big constructive interests" who could avail themselves of them. But high real interest rates also advantaged the little American saver.

In the days before the governmental safety net, thrift was a life-saving virtue. The unemployed could fall back on friends, family members, charity — and their own savings. In 1920, the nation's mutual savings banks counted 9,445,327 depositors with aggregate deposits of $5,186,952,000. At an average of $549.16 per passbook, that was 40.9% of the $1,342 average national wage. In 1921, the population of depositors rose by 1.8%, the average deposit by 5.5%.

Most of these deposits were rainy day funds, a New York savings banker was quoted as saying in July 1921, "and it has been our experience that it must rain very hard to make a wide change in the totals. The average man or woman with a savings account considers it a sort of final line of defense, and we have records of extraordinary lengths to which depositors will go rather than dip into their accumulation."

In New York, savings banks paid 4% on deposits, a handsome rate when the cost of living was falling. That, however, was not so handsome as 5% or 6%, which is what high-grade bonds were paying in the summer of 1921 — and paying in denominations small enough to entice the typical savings bank depositor. So it was that New York savers withdrew a net $21.1 million in the third quarter of that year. The rare outflow of deposits reflected, first, the poor job market, and, second, better opportunities outside the walls of one's local mutual savings bank.

For any without access to the forecasts of the big constructive interests, a tip from a mailman would have almost sufficed. In May 1922, postal receipts showed a year-over-year gain of 14.4%. In the final six months of 1922, a billion more stamps were issued than in the like period of 1921. In fiscal 1921, the Post Office had run a $60.8 million deficit. In the early weeks of 1923, it appeared as if that deficit were going to be erased.

Likewise could an acquaintance in the railroading field have been a source of useful economic information. By the time accounts were cast at the end of 1922, railroads had moved more agricultural tonnage than in any year of their history. A coal strike led to an overall drop in tonnage vs. the year earlier. However, while 470,406 railroad cars had sat idle in 1921, the railroads were more than 105,000 cars short in 1922.

The fact is that in just about every branch of American business and finance — agriculture was the large and troublesome exception — things were humming. In 1921, there were just 17 days on which trading volume on » *continued on page 38*

# Shavers, Sharks and Payday Lenders

By Robert E. Wright

Westerners have long harbored a love-hate relationship with lenders, and their ambivalence shows no sign of abating anytime soon. What has changed over time is the perception of what constitutes "bad" types of lenders or loans. In various times and places, it was illegal/immoral to charge any interest at all, to exact interest from kinsfolk, to charge rates considered too high or to use violent collection methods. Today, it is lawful, and even somewhat morally acceptable, to charge any rate of interest to anybody willing to pay it. Reformers, however, want to protect borrowers from being cajoled, forced or tricked into borrowing at high rates for long periods.

The King James version of Exodus (22:25) states that "If thou lend money to my people poor by thee, thou shalt not be to him as a usurer, neither shalt thou lay upon him usury." Usury here is usually taken to mean taking any interest whatsoever, though at least one recent translation reads instead: "If you lend money to one of my people among you who is needy, do not treat it like a business deal; charge no interest." If the traditional interpretation is correct, perhaps early Jews lamented lost profit opportunities because Deuteronomy (23:19–20) clearly allows some lending at interest: "Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury."

Stranger is usually taken to mean a non-Israelite or non-Jew, which was the general interpretation when Shakespeare penned *The Merchant of Venice* and *Hamlet*. The former featured an anti-Semitic caricature of an avaricious moneylender while the latter contained the most infamous anti-financial line of all time: "Neither a borrower nor a lender be." In *David Copperfield*, Charles Dickens warned that even a small annual budget deficit could lead to ruin: "Annual income 20 pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery." Clearly, the Western world has had a long and complex relationship with debt.

By the 18th century, charging/paying interest was a quotidian activity in most of Europe and America. Benjamin Franklin, writing as Poor Richard, tried to persuade readers that "the borrower is a slave to the lender," but what early Americans deprecated was exacting *excessive* interest, or "usury" in the modern sense of charging unlawfully high interest rates. That sentiment was perhaps best expressed by South Dakota banker Porter P. Peck. The first lenders on the frontier had very bad reputations, he explained, because they were "the genuine old money shark who went on with the first axman or prairie schooner." They did no good except to "pave the way for the more liberal class who followed. This latter class came on

and charged only 5% a month for money. They were, of course, much better thought of, and the pioneers voted to let them remain on sufferance."

In other words, lending/borrowing was acceptable in America only if rates were not *too* high, a line that varied dramatically over time and place depending on the level of economic development (higher in less developed areas) and financial development (lower in more developed systems) and the type of monetary system (higher under inflation-prone fiat regimes).

Regardless of the location of the "too much" line, lenders willing to lend at usurious rates could always be found, although not until recently in sufficient numbers to keep rates near a competitive level. Before the Civil War, usurious lenders were typically called "note shavers" because they purchased promissory notes (the note) at steep discounts (the shave) from the face values on which interest was calculated.

"I cannot [lawfully] lend money on bond and mortgage at a rate exceeding 7% per annum interest," explained one New Yorker in 1837, "but I may buy a bond and mortgage at 20, 30 or 40% less than the face of it; which gives me actually an interest of 9, 10 or 12% per annum."

Antebellum banks generally charged rates at or below the legal maximum because lending at usurious rates could endanger their charters (their licenses to issue lucrative bank notes) and also (due to adverse selection) their capitals. So instead of servicing the illegal high risk-high return market themselves, banks lent to note shavers who, in turn, made the usurious deals. Note shavers were attracted to high returns and the low expected cost of getting caught (the probability of being successfully prosecuted times the penalty imposed).

After the Civil War, the term "note shaver" began to give way to "loan shark." Sharks were later cast as entrepreneurs providing a much needed service, but at the time they were almost uniformly castigated as bloodhounds, charlatans, leeches and worse because their tactics were so unpalatable. Unsurprisingly, most usurers remained unincorporated and changed names and addresses frequently in order to remain as innocuous as possible. To garner some economies of scale, they formed interstate networks of agents, the largest of which operated in more than 60 cities.

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By the early 20th century, the term loan shark was in common use, and its negative connotation — sharks were then considered "evil" predators — was considered "unmistakable." In 1911, for example, Vaudevillian Harry Lauder sang, "Think of the sharks that we see in the sea, and think of the sharks that are not in the sea, that ought to be in the sea!"

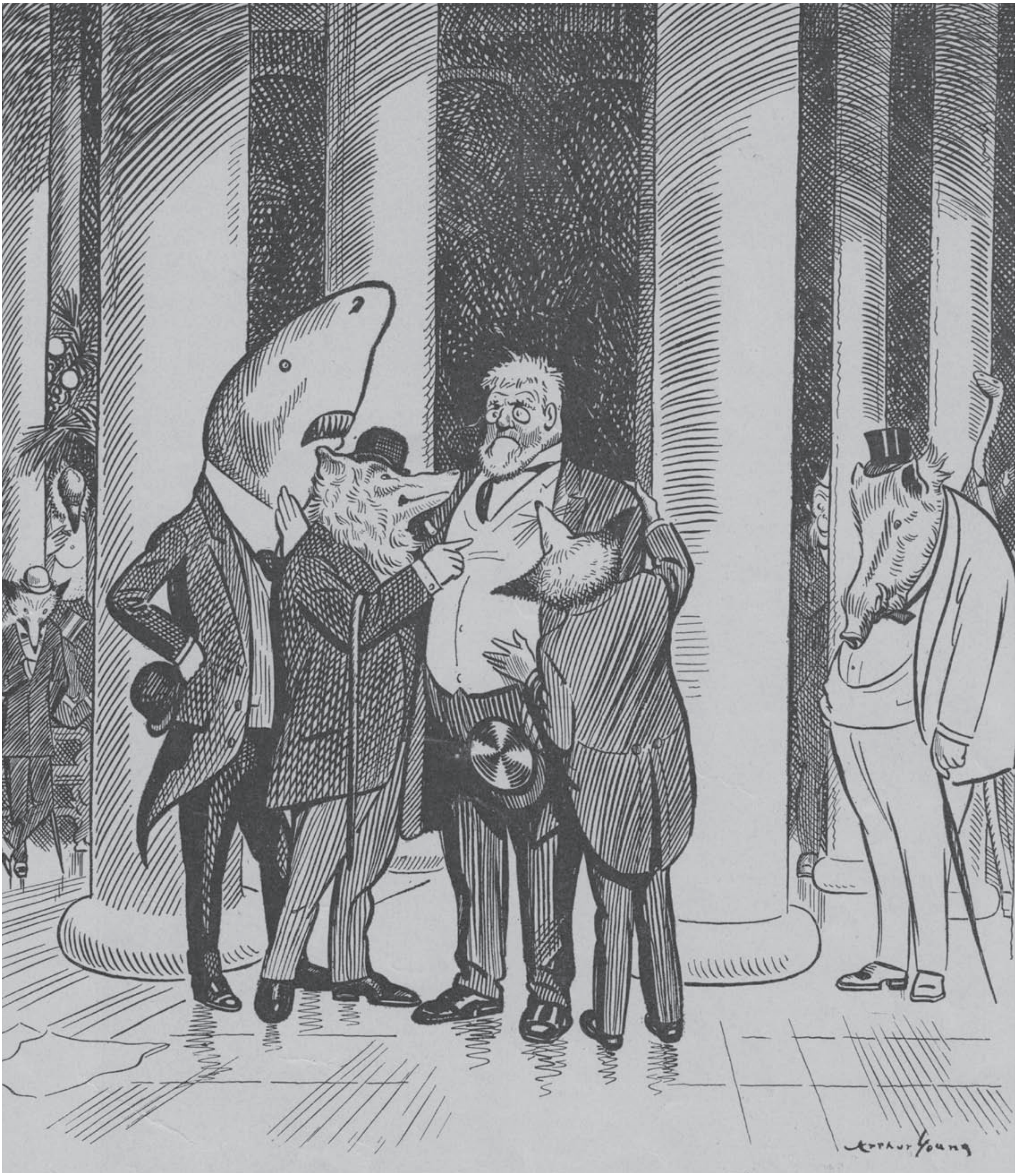
Interestingly, early sharks rarely resorted to violence but rather took advantage of their borrowers' ignorance of the law. Most ensnared their victims by having borrowers sign papers that they did not understand, often replete with blanks that were filled up later. Sharks collected the sums due not through the courts but by bluffing legal action and other methods that were said to "cause prolonged worry, destitution and sometimes suicide."

Many collectors were females who verbally berated defaulters in public places to shame them into paying. Sharks also threatened to tell employers about wage assignments, which was often grounds for immediate dismissal. Other times, as a loan condition, sharks had borrowers draw a bad check and then threatened to turn the borrower over to authorities and prosecute them for fraud unless they immediately paid up. Or, they pointed to irregularities in the loan application (usually in a form detailing present indebtedness) and threatened to press fraud charges.

Loan sharks largely remained under the sonar of Progressive reformers until the early 20th century, when contemporaries came to see "the utterly inhuman methods prevalent nowadays of handling what should be a legitimate business." Reformers likened the small loan business to a "new system of slavery" or debt peonage because many borrowers found it impossible to extricate themselves from the jaws of the shark because the principal had to be repaid in a lump sum rather than in installments. One widely reported study, completed a few years before World War I, revealed that about one in every three poor working families borrowed from sharks, enough to support one shark for every 5,000 or 10,000 people in urban centers like Pittsburgh.

Such statistics energized an extermination effort led by the Russell Sage Foundation and comprised of publicity campaigns, new regulations and the formation of substitute lenders. Substitutes included non-governmental organizations (NGOs) like fraternal orders that charged no interest, Remedial Loan Societies that produced profits capped by law, mutuals and co-ops like credit unions owned by borrowers, and for-profit businesses that adhered to state usury laws. To encourage the formation of substitutes, some reformers cognizant of the high costs associated with making numerous small loans advocated raising legal interest for small lenders into the 20–40% per year range. Russell Sage Foundation lawyers also drafted a Uniform Small Loan Law that eventually was passed, albeit often in diluted form, in about 35 states.

Despite those efforts, the number, geographical reach (even into small agricultural towns in the heartland) and business volume of loan sharks increased markedly, from about $21 million in 1923 to $72 million in 1939, which brought them under the increased scrutiny of governments and NGOs. Penalties remained minimal, however, so the effectiveness of legislation was limited as "wily and ingenious" usurers developed sophisticated new scams, some involving automobile titles. Unlike corporate lenders and pawnbrokers, however, sharks looked primarily to their borrowers' incomes, not collateral, for security. They thrived more on middling wages and bad luck or improvidence than on abject

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*Life* magazine cartoon by Arthur Young, entitled
"The Animals He Meets When He Has Money to Invest."

poverty, as it was difficult to exact high rates of interest from somebody who had no money.

As the Depression gave way to World War II, a few states had largely exterminated their sharks. In most states, however, sharks continued to thrive so alternatives, especially credit unions, again touted themselves as the way to "keep away from loan sharks!" In a 1940 pamphlet, proto-Keynesian economist William Trufant Foster (1879–1950) exposed the "modern loan shark," men who could turn $20 into over $1,000 in just nine years by becoming a "bootlegger of small loans" in states — like Florida, Georgia, Missouri, Oklahoma, Tennessee, Texas and Washington — that prevented legitimate lenders, like banks and credit unions, from flourishing. "Never has a campaign to enforce a 10% usury law," he explained, "prevented wage earners from borrowing money at 240%" because the demand for small consumer loans was so pervasive.

Foster claimed that loan sharks lobbied *in favor* of maintaining or even lowering usury rates because "low legal interest keeps out legitimate lenders" like "*legal, stringently regulated* personal finance companies" that could lend profitably at rates between 24–42% per year. Foster was particularly peeved at well-meaning but uninformed persons who unintentionally aided loan sharks by pushing for lower usury ceilings or repeal of the Uniform Small Loan Law. "Persons who are uninformed, but of good intent," he lamented, "cooperate with persons who are well-informed, but of evil intent."

Payday lending began in a tentative way during the Civil War, was common by the 1910s and was pervasive by the early 1940s. In order to avoid anti-sharking legislation, early payday lenders bought the right to collect a part of the borrower's wage on his or her next pay day, kept no books, blacklisted people who asked for receipts and did business across state lines through the use of agents. As Foster explained, "this often means that only the agents can be reached, not the culprits higher up and farther away." The agents claimed to own no assets, "not even their office desks."

After World War II, banks, credit unions, finance companies and specialized small loan companies began to offer substantial quantities of short-term signature loans to America's increasingly affluent working class, and their competition forced the old school loan shark far offshore. Nevertheless, the civil penalty for exacting usurious interest remained very low, ranging from loss of excess interest to loss of all interest and principal; it was a criminal offense in only a few states, and even in those places it was just a misdemeanor. Unsurprisingly, then, loan sharking came to be dominated by gangsters.

This new breed of shark, which evolved in the New York City underworld during the Great Depression but did not increase its range nationally until the early 1950s, treated the body of the borrower and the lives of his family members as the ultimate security for loans and interest payments on the order of 5% per week. Organized crime sharks also lent to small businesses and, when necessary, sucked business inventories dry in order to recoup their capital and "vigs," much as depicted in the HBO series *The Sopranos*.

By 1966, loan sharks tied to organized crime lent an estimated $1 billion at rates between 250 and 2,000% per year. Although their reputation for violence often rendered the actual breaking of thumbs and limbs unnecessary, violent loan sharks were considered such a pressing social problem that in 1968 Republican presidential candidate Richard Nixon made attacking them a "significant part" of his campaign. Congress responded by passing the Consumer Credit Protection Act of 1968, which outlawed "extortionate credit transactions" in an effort to undercut the "economic foundations of organized crime."

The act imposed stiff penalties (up to a $10,000 fine *and* 20 years imprisonment) for the use of violence, or the threat thereof, in credit collections. By degrees, the government largely killed off the organized crime shark, partly by vigorously suppressing organized crime syndicates and partly by fostering lawful alternatives.

The result of the latter policy was the modern payday loan industry, a rapidly growing beast that made $14 billion in loans out of about 10,000 offices in 2000 and $27 billion out of 22,000 locations in 2012. Many experts argue that the modern industry is highly competitive and hence the rates charged, high as they are, are fair because they represent the risks and other costs associated with making numerous small loans. High rates on small sums for short periods do not amount to much money, they note, so many borrowers are actually better off getting a payday loan than having their electricity, heat or water turned off or paying bounced check fees.

Other experts, however, retort that many borrowers (more than half in many states) roll over their loans from paycheck to paycheck because they cannot repay the principal or because the lender makes it difficult for them to do so. As a consequence, borrowers end up paying far more in interest and fees than they anticipated. State payday loan regulations vary greatly, providing researchers with clues about the extent to which specific regulations, like rollover prohibitions, help to prevent borrowers from falling into the maw of this most recently evolved species of shark.

The debate, in other words, is no longer over the price of borrowing but the exact terms of the loan and its repayment. "Debt trapping ought to be prohibited," as Robert Mayer put it. $

*Robert E. Wright is the Nef Family Chair of Political Economy at Augustana College in South Dakota and a member of this magazine's editorial board. He is the author of more than 15 books including* One Nation Under Debt *(2008) and is the co-author, with Museum Chairman Richard Sylla, of* Genealogy of American Finance *(Columbia Business School Publishing, Spring 2015).*

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# Debt and Democracy

## *Forging a More Perfect Union*

**By Edward J. Larson**

The drive to establish a new Constitution for the United States during the late 1780s and replace 13 sovereign states with one energetic national union had many sources. But perhaps none was more important than debt. Congress and the states had run up massive foreign and domestic debts during the Revolutionary War that, with peace, were falling due. Although some states had less debt or more resources than others, all of them at least had the power to tax citizens and impose tariffs to finance past debts and fund current services. Congress did not. It lacked the means to pay even interest on its debt, much less repay principal.

During a period of nationalist ascendency from 1781 to 1783, Congress made two attempts to get the general government's fiscal house in order by passing measures to impose a 5% duty on imported goods. The first would have been collected by national agents; the second, in a concession to the states, would have been collected by state agents and transferred to Congress. Under the Articles of Confederation, however, all 13 states needed to approve any national tax, and neither plan gained universal assent.

Congress was forced to rely on requisitions from the states, which often went unpaid. In a 1786 letter to the Confederation's brilliant but beleaguered Foreign Secretary John Jay, the then retired but still concerned wartime Commander-in-Chief George Washington lamented, "Requisitions are a perfect nihility where 13 sovereign, independent, disunited

Library of Congress

George Washington full-length portrait by Charles Willson Peale, circa 1918.

States are in the habit of discussing and refusing compliance with them at their option."[1] Most of the nation's war-related debts were owed to Americans, however, and represented the collective obligations of all the states. If Congress failed to repay them, then the states could step in to take care of their own citizens and, by doing so, supplant Congress in the hearts, minds and wallets of their people. At the time, this represented an ultimate threat to federal union.

The scheme was simple and the results potentially debilitating for the central government. In every state, Congress owed money to public creditors: persons holding bonds or other securities issued during the war for money, goods or services. Many of these securities — which originally went to a large number to lenders, suppliers and veterans — had passed into the hands of a small number of speculators, who purchased them at a discount.

In turn, the states owed annual requisitions to Congress, and public creditors owed taxes to their states. As long as Congress was unable to pay public creditors, the states could accept national securities from their citizens as payment for state taxes and apply them at face value toward their requisitions. Congress was obligated to use most of its revenue for debt financing anyway. By inserting itself as a middleman between Congress and public creditors, a state could assure that its requisitions went to repay its own citizens rather than foreign and domestic public creditors generally.

Of course, if states accepted securities at face value for tax payments, speculators who purchased them at discount would stand to gain. Those speculators and their allies in government became the principal supporters of the scheme in many states. For them, it was profitable; for the states, it was efficient; for Congress, it was disastrous.

Congress might object to states meeting their requisitions by offsetting debt obligations rather than remitting hard money, but it could do little about it since many states did not pay their full requisitions and specie was scarce. Every nationalist knew the power to tax was the power to rule. Without it, Congress had to take what it could get from the states, and it was rarely hard money. One reckoning put the total amount of cash turned over to Congress by the states during the period from October 1786 to March 1787 at $663, or a mere 2% of the August 1786 requisition.[2]

Ever since the war began, hard money in the form of internationally accepted gold and silver coins had been in short supply throughout the states. At the time, Americans relied on other countries for specie, with Spain's gold dollar being especially popular. As these coins passed overseas to pay for imported goods and repay foreign loans, Congress tried to make up the deficit by printing paper dollars, called "Continentals," but stopped in 1779 after their value collapsed.

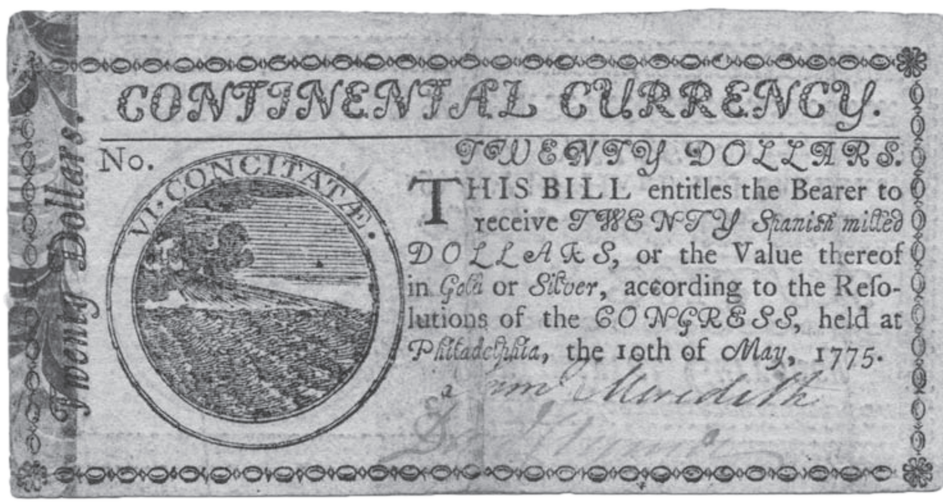
By 1781, a Continental was worth half a cent and even Congress refused to take them.[3] During the war, state-issued paper money did not fare much better. Most suffered hyperinflation. People wanted hard money or paper backed by something of more certain value that a shaky government's doubtful promises. The states moved in to fill this monetary vacuum.

The attack on Congress's control over the national debt and money supply began in Pennsylvania, which had the country's most democratic state constitution. Adopted in the revolutionary fervor of 1776, less than three months after the Declaration of Independence, Pennsylvania's constitution abolished property qualifications for voting, established a one-house legislature with all seats elected annually and gutted traditional checks and balances by having the President, Supreme Executive Council and judges appointed by the legislature for short terms and removable at will. More than in any other state, the people ruled in Pennsylvania — but they did so as a majority faction that was sensitive to manipulable shifts in popular opinion.

In 1782, when an all-but-bankrupt Congress stopped paying interest on its domestic debt, Pennsylvania began issuing state certificates of interest on that debt to public creditors in its state in place of the unpaid interest. It then accepted them back in partial payment for a newly-imposed tax and credited the certificates toward its requisition instead of paying hard money to Congress. Once issued, Congress no longer owned the interest covered by the certificate but never obtained the hard cash that it needed to pay its other creditors or fund on-going operations.

Further, until redeemed in payment of taxes, the certificates circulated as a form of paper money within Pennsylvania. This stimulated the cash-strapped local economy, which was depressed due to the lack of hard money and the collapse of other forms of paper money. The certificates retained value because the state accepted them in payment of taxes and, as Pennsylvania's Benjamin Franklin famously observed during the 1780s, "in this world nothing can be said to be certain, except death and taxes."[4]

Emboldened by Pennsylvania's example, other states quickly adopted, adapted and expanded on the scheme. New Hampshire and New Jersey began offering certificates, or "revenue money," for unpaid interest within the year. By 1785, more than half of the states had implemented a




Collection of the Museum of American Finance

$20 continental currency, dated May 10, 1775 and signed by Samuel Meredith and Daniel Clymer. The polychromed left edge is attributed to Benjamin Franklin.

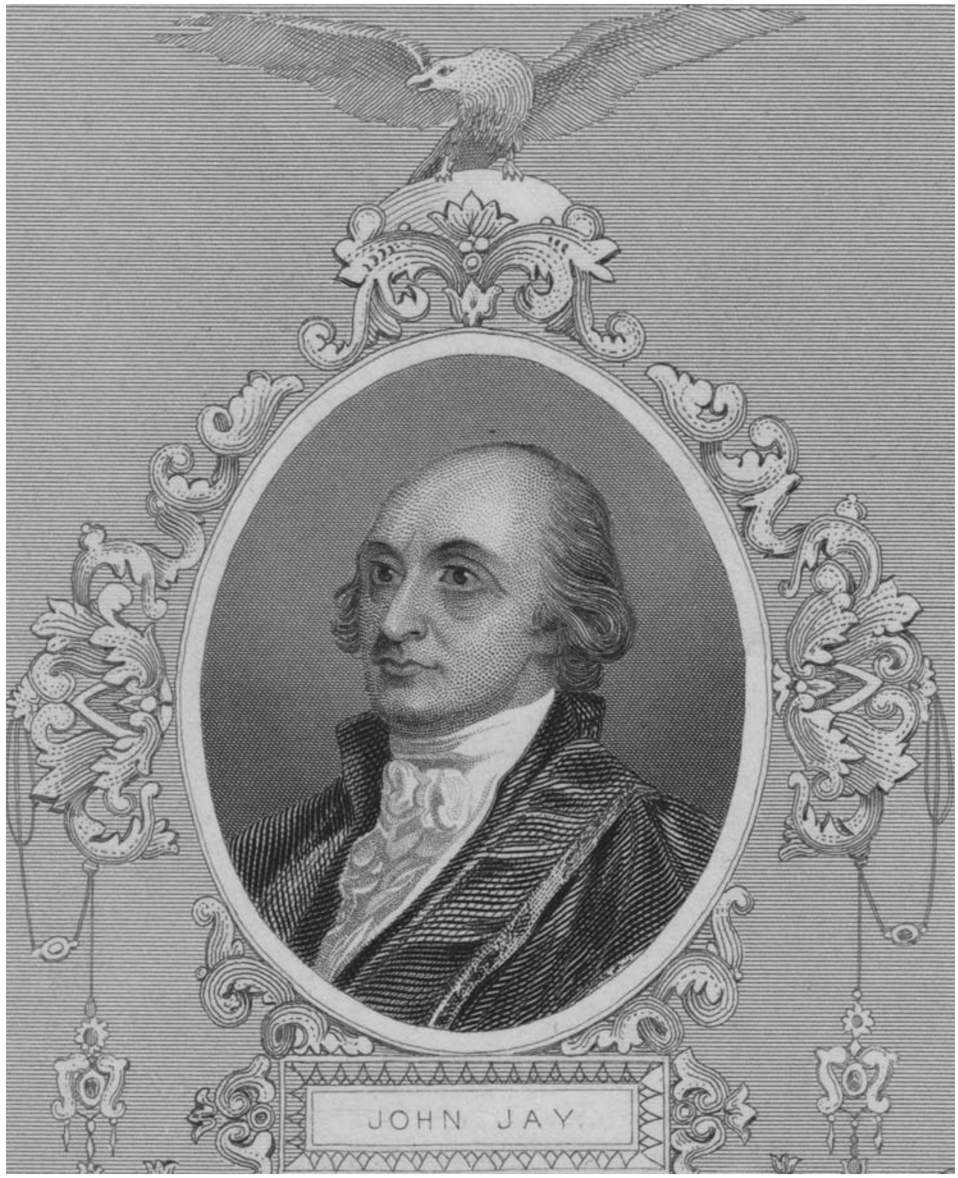
system of paying interest on their citizens' national securities. Once this ball started rolling, it was hard to stop, especially since it aggrandized the states.

Congress tried twice to regain control of its own debt. In 1784, it offered its own paper certificates, or "indents," in lieu of interest to public creditors, who then could redeem them through the states in payment of state taxes. Seeing nothing in this program for them, most states either refused to implement it or implemented it so poorly that it had little impact.

A year later, Congress attempted to bar states from paying their requisitions with state interest certificates, but this backfired badly. Some states ignored the mandate; others, again led by Pennsylvania, got around it by calling in all or part of the national securities held by its citizens and exchanging them for state bonds that typically paid interest in some form redeemable as tax payments. The states then fulfilled their current requisitions to Congress by offsetting the interest or principal owed on these securities and held the remainder either to pay later requisitions or for any future reconciliation among the state and national governments over war-related debts.

By 1786, the states had assumed much of the total national debt, with Pennsylvania, New York and Maryland alone holding nearly one-third of it. Congress was rapidly becoming irrelevant. By replacing state bonds for national securities, the loyalties of public creditors shifted from the nation to the states. And the flood of new state bonds, many of which were issued in small denominations and circulated almost like cash, addressed the urgent economic need for currency without involving Congress.

Severe deflation in the value of hard money had caused a nationwide recession that a well-regulated emission of paper credit could ameliorate. Many cautious Americans doubted, however, that elected state legislatures could regulate it well. In a June 1786 letter to Washington, Jay described these paper-money skeptics as "the better kind of people – by which I mean the people who are orderly and industrious, who are content with their situations, and not uneasy in their circumstances." This sort, he warned, "will be led by the insecurity of property" to question republican rule and "prepare their minds for almost any change that may promise them quiet and security."[5]



Collection of the Museum of American Finance

Engraved portrait of statesman John Jay.

Washington agreed and found it "much to be feared … that the better kind of people" might resort to a monarchy or worse. "We are apt to run from one extreme into another," he wrote back to Jay. "To anticipate and prevent disastrous contingencies would be the part of wisdom and patriotism."[6]

Jay's fears notwithstanding, the benefits from expanding the money supply through state-issued bonds and interest certificates revived popular demands for states to issue paper money. The wartime experience with hyperinflation, which hit creditors like Washington especially hard, had soured many wealthy Americans on paper money. Having lent out money in pounds sterling prior to the Revolutionary War, for example, Washington was repaid during the war in depreciated paper money worth less than one fourth its face value—and he never forgot it.

In 1786, as demands for paper money grew, Washington depicted the practice of repaying hard cash with inflated paper money as "ungenerous, not to say dishonest." He would not do it to his creditors and did not want his debtors to do it

to him. "Paper bills of credit," he complained, give "the shadow for the substance of a debt."[7]

Even less restrained in their words, Jay, Virginia Congressman James Madison and many other leading nationalists denounced state-issued paper money in the strongest terms. Arguing against its issuance by his state in 1786, for example, Madison lectured Virginia's legislature that paper money would "destroy confidence between individuals" and "disgrace republican gov[ernmen]ts in the eyes of mankind."[8] Yet under the Articles of Confederation, Congress was as powerless to prevent states from issuing paper money as it was to stop an incoming tide. Creditors like Washington, who feared that cheap paper money would erode the value of fixed investments, were swimming against that tide in trying to prevent state legislatures from authorizing it. At most, opponents could try to limit its use to paying taxes or have it secured by something of value, such as state-owned land.

The dam broke in 1786, when seven states emitted paper money. "Pennsylvania and North Carolina took the lead in this folly," Madison wrote in August to Thomas Jefferson, who was then serving as America's ambassador in Paris. Most of the initial emissions incorporated limits that helped them to hold value at least initially, but in debtor-controlled Rhode Island, which made its paper money legal tender for virtually all public and private debts, the bottom dropped out of the currency's value almost immediately and hard money was driven underground.

"Supplies were withheld from the market, the shops were shut, popular meetings ensued and the state remains in a sort of convulsion," Madison told Jefferson. "Depreciation is inevitable" in every state with paper money, Madison predicted, yet driven by popular factions, he feared that more states would join others in printing "this fictitious money."[9]

Madison perceived a pattern in the rush to paper. State governments with the fewest checks and balances tended to act first and in the most extreme manner. Pennsylvania and Rhode Island, for example, placed all power in the legislature, with the executive and the judiciary serving at its pleasure. In contrast, he observed in his letter to Jefferson, Maryland held back because the state Senate — presumably because of the long terms, indirect selection process and property qualifications of its members — stood as "a bar to paper in that state."

But as "the clamor for [paper money] is now universal, and as the periodical election of the Senate happens at this crisis," Madison added with his customary pessimism, Maryland's next Senate will likely surrender.[10] This experience confirmed his view that America needed a balanced national government that could check the power of state excesses and majority factions. From Paris, Jefferson had sent Madison a shipment of treatises on government by European political philosophers that arrived early in 1786. Now he began trolling through them in earnest for arguments in support of his view.

Expressing similar sentiments at the same time, Washington wrote to former Congressman Theordorick Bland in August 1786, complaining about "the *present alarming troubles* in Rhode Island."[11] Writing to Jay on the same day, Washington added, "What a triumph for the advocates of despotism to find that we are incapable of governing ourselves, and that systems founded on the basis of equal liberty are merely ideal and fallacious! Would to God that wise measures may be taken in time to avert the consequences we have but too much reason to apprehend."[12]

For nationalists, Rhode Island became an object lesson in the dangers of excess democracy and a clarion call for constitutional reform. Proponents of paper money pointed to the success of other states in preserving its value, but critics saw it from Madison's perspective and, all but giving up on the states, turned toward the nation for salvation. Referring to related developments in New Jersey, Madison asked James Monroe earlier in 1786, "Is it possible with such an example before our eyes of impotency in the federal system, to remain skeptical with regard to the necessity of infusing more energy into it?"[13]

Echoing these sentiments in his August letter to Jay, Washington wrote, "I do not conceive we can exist long as a nation, without having lodged somewhere a power which will pervade the whole Union in an energetic a manner." Significantly, he then added, "Retired as I am from the world, I frankly acknowledge I cannot feel myself an unconcerned spectator."[14]

The specter of unpaid debt, and the states replacing Congress as the functional center of governing authority drew Washington, Madison, Jay and the other nationalists to the fore — driving them, and their country, to a new Constitution and a more perfect union that would forever change the nature of government. $

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## Notes

1. George Washington to John Jay, Aug. 15, 1786, PGW CS 4: 213.
2. Ray Raphael, *Constitutional Myths: What We Get Wrong and How to Get it Right* (New York: New Press, 2913), 21.
3. For an analysis of the value of Continentals, see E. James Ferguson, *The Power of the Purse* (Chapel Hill: University of North Carolina Press, 1961), 51–52
4. Benjamin Franklin to M. Le Roy, Nov. 13, 1789, ed. Jared Sparks, *Works of Benjamin Franklin* (Boston: Hilliard, 1840), 10: 410.
5. Jay to Washington, June 27, 1786, PGW CS 4: 131–32.
6. Washington to Jay, Aug. 15, 1786, PGW CS 4: 213.
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11. George Washington to Theodorick Bland, Aug. 15, 1786, PGW CS 4: 211.
12. Washington to Jay, Aug. 15, 1786, PGW CS 4: 213.
13. James Madison to James Monroe, Apr. 9, 1786, PJM 9: 25.
14. Washington to Jay, Aug. 15, 1786, PGW CS 4: 212–13.

# WHO PAID TO DEFEAT HITLER?

**By Nicholas Wapshott**

Who paid for the war to defeat Hitler and the Axis powers? The short answer is the United States. The intervention of the financial and industrial might of America after Pearl Harbor in December 1941 ensured that it was only a matter of time before Nazism, Italian fascism and the military junta that ruled Japan would be routed.

But the surprise attack on the US Pacific fleet came more than two years after World War II had started, in September 1939. Until Congress declared war on Japan and Hitler declared war on the United States in the dying days of 1941, the war against the Axis was overwhelmingly paid for by the European Allies. And after the fall of France in 1940, Britain (and for a short time Greece) fought fascism alone — with minimal help from America.

Until Pearl Harbor, a large proportion of Americans were isolationist, believing in the dictum laid down by Presidents Washington and Jefferson that the US should "avoid foreign entanglements." Wall Street had largely funded World War I, through loans to Britain, who borrowed on behalf of France and Italy, and by the mid-1930s, when Japan invaded Manchuria, Italy invaded Abyssinia (today's Ethiopia) and Germany started its long march through Austria, the Sudetenland, Czechoslovakia, then Poland, much of the debt remained unpaid.

The Johnson Act of 1934 forbade sales of arms to countries who owed money to the United States and that, along with a succession of Neutrality Acts intended to keep America out of European affairs, made it difficult for President Franklin Roosevelt to help the western Allies. (Providing military help to the Soviet Union was an even more difficult problem, even before the Hitler-Stalin pact that bought the Russians time to rearm.)

There was a break for Britain when Congress allowed limited military aid to be sold on a cash-and-carry basis, so long as it was collected in British ships. But otherwise Britain and its empire — which then included Australia, New Zealand, Canada, India, South Africa and many other colonial nations — were left to fend for themselves. Roosevelt may not have agreed with the Neutrality Acts and spent a great deal of political capital trying to have them rescinded, but he was well aware that the gradual impoverishment of Britain suited his larger purposes.

A devotee of Woodrow Wilson's ambition to have the United States become the leading nation of the world, a supporter of the idea of world government through the League of Nations and a believer in Wilson's notions of self determination for all nations, Roosevelt was an anti-imperialist who wished to bring a swift end to the British Empire. World War II offered him that opportunity.

Recent joint biographies of Roosevelt and the wartime British prime minister Winston Churchill have stressed what the two men had in common — a love of Anglo-Saxon culture, a sense of noblesse oblige and a fondness for alcohol — rather than what divided them. But FDR was a progressive liberal Democrat and Churchill an unashamed imperialistic Tory. And no issue illustrated the sharp difference between them more than whether the British Empire should survive into the post-war world. Churchill saw the Empire as a dignified, patrician and benevolent institution; Roosevelt thought it exploitative, unfair and unkind.

Roosevelt felt that once fascism was defeated, the United States should proudly assume the responsibilities of the richest, most powerful nation in the world and that the Pax Britannica should give way to a new Pax Americana. The war gave the President the chance to seal the fate of the wobbling British Empire, which held by force of arms much of the Middle East, Africa and India. The legitimacy of the Empire was already being tested by freedom movements, particularly in India. So long as the isolationists insisted Britain should not be helped in its fight against Hitler, Roosevelt was able to press Churchill for the speedy liquidation of British assets.

But it was with mixed feelings that Roosevelt presided over the impoverishment of Britain. If too little financial and military help were provided to Britain, the United States would be left to fight the Axis nations alone. By the end of 1939, British gold and dollar reserves stood at $545 million ($9.2 billion in today's dollars) and were diminishing at the rate of $200 million ($3.4 billion) a year. Since Britain declared war against Germany in September 1939, Britain had spent $4.5 billion ($76 billion) in cash with American arms manufacturers and had only $2 billion ($34 billion) left in cash reserves, which would last only until the middle of 1941. Anxious that Britain might default, American exporters of food and other supplies had begun asking for cash up front.

But Britain's funding of American arms manufacturing was essential to America's urgent efforts to rearm against the day the Axis turned on them. By the end of 1940, Britain had invested $2 billion ($34 billion in today's dollars) in American arms companies, including $880 million ($15 billion) constructing state-of-the-art warplane plants. Roosevelt worried that if the British were to go broke they may no longer be able to afford to invest in new war equipment factories and provide thousands of American jobs.

The British ambassador in Washington, Lord Lothian, gave the New York press an exaggerated account of Britain's financial embarrassment when he arrived on a flight from London on November 23, 1940. "Britain is bust," he said, before explaining that matters were "becoming urgent" and that "available gold and securities had been virtually used up."

The Brits were not yet bankrupt. Roosevelt told his cabinet, Britain "still has sufficient credits and property in this country to finance additional war supplies. … [and that the $2.5 billion ($42.4 billion) in assets remaining] ought to be spent first, although the British do not want to liquidate their American securities." To that end he asked Britain to provide an account of its remaining wealth and instructed his Treasury Secretary, Henry Morgenthau, to explore what assets could be transferred to America. It was the first time a sovereign nation had opened its books to another.

On December 1, Morgenthau showed Britain's balance sheet to the President. Roosevelt glanced briefly at the figures before throwing them on the desk, saying, "Well, they aren't bust. There's lots

Library of Congress

Wreckage of the *USS Arizona* in Pearl Harbor, December 7, 1941.

of money there." The same day, Roosevelt told the US ambassador in London, Joe Kennedy, the same. "I've gone over their financial position and they're all right for quite a while," he said. "They've got plenty in the [sic] South [Africa] and holdings all over the world."

Three days later, Sir Frederick Phillips, a British Treasury official, returned to Washington to resume negotiations that had been going on with Morgenthau for some months to establish "a factual basis of British financial resources and war supply expenditures." Phillips was working to a brief written by the British economics genius John Maynard Keynes, who had instructed Phillips that Britain would not "accept the dishonor and the reproaches of default whilst allowing to the US all the consequent conveniences to their trade." If Britain were deliberately beggared, Keynes foresaw "revolutionary changes in the commercial relations" between the two countries that would involve the closure of British and Empire markets to American exporters as soon as the war was won. "America must not be allowed to pick out the eyes of the British Empire," Keynes wrote.

It soon became clear in London that it would have been better if the silver-tongued Keynes, rather than the lackluster Phillips, had argued the British case. Morgenthau put pressure on Phillips to immediately liquidate valuable national assets, such as British ownership of South American railroads, and tin mines and rubber plantations in Malaya. At one point Roosevelt asked Phillips straight out, "How about selling some of those securities you have in Argentina?"

Morgenthau wanted to get American hands on important British-owned companies in America, such as Shell Oil, Lever Brothers and Brown & Williams Tobacco. At the insistence of Morgenthau, Courtaulds, the giant plastics and chemicals company, was sold in 1941 to American buyers at a fraction of what it was worth. Britain had had its pockets picked.

That was not all. Roosevelt and Morgenthau pressed their advantage, insisting that a US warship be sent to Cape Town to pick up $50 billion ($848 billion in 2014 dollars) in British gold holdings. Picking over their financial bones was humiliating to the British, and one government minister complained "that the Americans' love of doing good business may lead them to

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President Franklin D. Roosevelt (supported by his son, James) and British Prime Minister Winston Churchill at the Atlantic Conference in August 1941, where they delineated the common goals of America and Britain in seeking a lasting peace that would end conflict in Europe.

denude us of all our realizable resources before they show any inclination to be the Good Samaritan." Churchill drafted an anguished letter to Roosevelt saying the American gold grab "would wear the aspect of a sheriff collecting the last assets of a helpless debtor." For fear of offending the President, the note was never sent.

This mercenary approach by America to its lone anti-fascist ally was kept a secret at the time and has only rarely been articulated and enumerated by post-war historians. For Churchill, it was shaming that Britain should be reduced to a supplicant, and it was a personal disappointment to him that Roosevelt should press his financial advantage at a time when the British stood alone against a wicked ideology intent on world domination; for Roosevelt it, too, was something of an embarrassment, but one he was prepared to endure if he was to place America at the top of the new post-war world order.

As 1941 progressed, Roosevelt ran out of British assets to take. And from that moment the President came face to face for the first time with the burdens of empire. In a memorandum to Secretary of State Cordell Hull, FDR explored whether America should demand territory from

Britain for armaments. He speculated on confiscating Bermuda, the British West Indies, British Honduras and British Guiana. But he could not decide whether acquiring poor colonies would be "something worthwhile or a distinct liability. If we can get our naval bases, why, for example, should we buy with them two million headaches, consisting of that number of human beings who would be a definite economic drag on this country?" Similarly with a number of small, lonely British dependencies in the Pacific, "the islands south of Hawaii (Canton, Enderbury, Christmas, the Phoenix group, etc. down to Samoa) and the islands southwest of Hawaii and south of the Japanese mainland." Roosevelt told Hull, "If we owned them, they would be difficult to defend against Japan."

Eventually, Britain also ran out of ready cash, and it became clear that Roosevelt would have to find a way to circumvent the Neutrality Acts. As always when he wanted time to brood on an apparently insoluble problem, Roosevelt booked himself onto a US Navy ship, to sail up and down the eastern seaboard while he was given time to think.

On Thanksgiving 1940, Roosevelt asked his cabinet to ponder in his absence how, in the circumstances of Britain no longer being able to pay for war materiel, America could continue to supply the last bastion of democracy against the dictators without having to run the gauntlet of Congress, which would find endless reasons to delay the provisions. Then, taking with him his close aide Harry Hopkins and a couple of other chums to make up a hand of cards, Roosevelt, in Frankfurter's words, "in a deep Lincolnesque mood," departed Washington for the naval dock in Miami to sail the high seas aboard the *USS Tuscaloosa*.

Roosevelt fished by day, sipped martinis at sunset, played poker by night and otherwise let it be known that he wanted time alone to ponder. A naval flying boat regularly delivered mail to the *Tuscaloosa*, and on December 11 a long dispatch arrived from Churchill. The President retreated from the rest of the party for the duration of the cruise.

For two days he lolled in a deck chair, reading and re-reading the letter that Churchill later recorded was "one of the most important I ever wrote." It suggested that Roosevelt's re-election the previous month confirmed that "the vast majority of American citizens" now believed that "the future of our two democracies and the kind of civilization for which they stand are bound up with the survival and independence of the British Commonwealth" and that "control of the Pacific by the United States Navy and of the Atlantic by the British Navy is … the surest means to preventing the war from reaching the shores of the United States."

Until America and Britain were fully rearmed, which Churchill thought would take at least two more years, it had fallen to Britain "to hold the front and grapple with Nazi power until the preparations of the United States are complete." Then came the nub. "The more rapid and abundant the flow of munitions and ships which you are able to send us, the sooner will our dollar credits be exhausted," Churchill wrote. The current orders for arms "many times exceed the total exchange resources remaining at the disposal of Great Britain. The moment approaches when we shall no longer be able to pay cash for shipping and other supplies."

While Britain was happy to foot the bill, Churchill said he hoped the President would agree that "it would be wrong in principle … if, at the height of the struggle, Great Britain were to be divested of all saleable assets so that after victory was won with our blood, civilization saved, and time gained for the United States to be fully armed against all eventualities, we should stand stripped to the bone."

Roosevelt returned to the White House on December 14. He told the waiting press, "I don't think there is any particular news, except possibly one thing that I think is worth my talking about." He continued:

> There is absolutely no doubt in the mind of a very overwhelming number of Americans that the best immediate defense of the United States is the success of Great Britain in defending itself and that, therefore, quite aside from our historic and current interest in the survival of democracy in the world as a whole, it is equally important from a selfish point of view of American defense that we should do everything to help the British Empire to defend itself.

At first, he said, he thought the only way to allow Britain to continue investing and ordering supplies from American factories was to repeal the neutrality laws and lend the Brits cash. An alternative would be for America to make a gift of "all these munitions, ships, plants, guns, etc." He also ruled that out. "I am not at all sure that Great Britain would care to have a gift from the taxpayers of the United States," he said.

But there was another way, he said, that did not involve money or mortgages or gifts. "What I am trying to do is to eliminate the dollar sign," he said.

> Suppose my neighbor's home catches fire, and I have a length of garden hose four or five hundred feet away. If he can take my garden hose and connect it up with his hydrant, I may help him to put out his fire. Now, what do I do? I don't say to him before that operation, 'Neighbor, my garden hose cost me \$15. You have to pay me \$15 for it.' … I don't want \$15. I want my garden hose back after the fire is over.
>
> If it goes through the fire all right, intact, without any damage to it, he gives it back to me and thanks me very much for the use of it. But suppose it gets smashed up — holes in it — during the fire. We don't have to have too much formality about it, but I say to him, 'I was glad to lend you that hose. I see I can't use it any more. It's all smashed up.' …He says, 'All right, I will replace it.' Now, if I get a nice garden hose back, I am in pretty good shape.

And thus Lend-Lease was born. In the subsequent debates in Congress about the plan, it fell to the arch-isolationist Senator Burton K. Wheeler to cut to the heart of the disingenuousness at the heart of Roosevelt's proposal. "If it is our war," Wheeler asked, "how can we justify lending them stuff and asking them to pay us back? If it is our war, we ought to have the courage to go over and fight it." $

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# Economic Titans

## DEBATE ON

# Free Trade Versus Protectionism

## IN 1869

**By Alan Lavine**

The Civil War was history. But by 1869, a new war had emerged as the United States set on a path to become the leading industrialized nation of the world. The nation, ravaged with debt from the war, needed to make money fast. Tariffs were seen by many as the most effective solution.

In the last four years of the 1860s, tariffs on all imports averaged 45%.

"Those interested in an expanded role for the federal government, whether building national roads…or paying for post-Civil War pensions, tended to approve higher tariffs," said University of California at Berkeley economist J. Bradford Delong, in his study on US trade policy. Delong, who also served as a Deputy Assistant Treasury Secretary under former President Bill Clinton, reported that those seeking higher tariffs joined political forces with a coalition of Northeastern and Midwestern manufacturers seeking protection against the British.

However, much like in today's Congressional battles concerning the overreaching role of government, not everyone supported the idea of raising government tariffs.

Free trade advocates believed that the rising tariffs on imports would become permanent. They blamed high tariffs on imported copper ore for the demise of Baltimore and Boston copper smelters. The tariffs resulted in rising copper prices, which led to falling demand.

American businesses that imported goods from overseas and US agricultural exporters, concerned over foreign taxes on their produce, pressed Congress for tariff reform.

Both sides of the issue of foreign tariffs were showcased in landmark public debates between two New Hampshire-born Republicans. They were Horace Greeley, a founder of the Republican Party and editor of the *New York Tribune*, and Arthur Latham Perry, an author and economics professor at Williams College in Williamstown, MA.

Political campaign print for Horace Greeley, editor of the *New York Tribune*, who was involved in a public debate on free trade.

The two squared off in four heated debates during the summer of 1869 that spanned St. Louis, Detroit, Boston and New York.

### How the Debates Got Started

The seeds of the post-Civil War US free trade movement sprouted in March 1865, when Treasury Secretary Hugh McCulloch appointed David A. Wells chairman of the country's revenue commission. His annual salary was $4,000 plus travel expenses. Wells, an economist, initially was a firm believer that tariffs on imports were required to protect American workers. His commission wrote revenue bills that reduced domestic sales taxes, but increased tariffs on foreign goods. Congress adopted them.

However, Wells abruptly changed his tune and ultimately was dismissed from his post following the failure of his last proposed bill to cut tariffs. Historians report that Wells, disgusted at all the influence peddling in Washington — especially by Pennsylvanians — changed his views following a fact-finding mission. He used his taxpayer-funded travel expenses to visit free-trade England. There, Wells studied the controversial British "Corn Laws," which, especially in the 18th and 19th centuries, regulated grain prices before their repeal in 1846. Though initially enacted to protect England's farmers and the country's food supply, the British regulations came under fire when they triggered higher costs that hurt British textile manufacturers.

In 1867, Wells, with Perry and William Cullen Bryant, editor of the *New York Evening Post*, helped launch the American Free Trade League, New York. The organization, of which Wells ultimately became president, committed to campaigning politically against tariffs on imports — except when truly needed for revenue.

The American Free Trade League sponsored lectures and published news articles and pamphlets supporting lower foreign tariffs. By 1869, they had built a war chest of more than $30,000, which would be worth more than $2 million today.

Horace Greeley, then 59, was an extremist favoring the tariff on imports. A friend of President Abraham Lincoln, he has been credited with founding the first national newspaper, the *New York Tribune*, and building its circulation to 300,000 readers. Greeley, often described as impolite and a poor dresser, was known as "Old Honesty" for his bluntness. He considered himself a champion of the working man, abolition and vegetarianism.

"If I had my way — if I were king of this country — I would put a duty of $100 a ton on pig iron and a proportionate duty on everything else that can be produced in America," Greeley once told the late President James A. Garfield.

### Arthur Latham Perry

Meanwhile, economist Arthur Latham Perry's text book, initially titled *Elements of Political Economy*, published in 1866, was becoming the bible of free trade. Its name subsequently changed to *Political Economy*. By 1876, it was the third best-selling economics book in the world, superseded only by John Stuart Mill's *Principals of Political Economy* and Adam Smith's *Wealth of Nations*. The book went through 22 editions. The deeply religious Perry, also a Williamstown minister, wrote for newspapers and delivered speeches promoting free trade.

Perry was 39 years old at the time of the debates.

"He used every economic argument he could command, appealed to common sense and enlisted the Creator, Scriptures and the Ten Commandments to prove that trade should be free," said John Bell, author of a *History of Economic Thought*.

### The Battle Over Tariffs

Under the sponsorship of the American Free Trade League, Perry and other league members barnstormed the country in support of their cause. Republican newspapers joined in support.

Greeley, an outspoken protectionist, may have proven the ideal candidate to debate Perry because his autobiography had just been published. Gray Williams, historian for the New Castle Historical Society Horace Greeley House in Chappaqua, NY, notes that Greeley was considered a 19th century rock star, drawing crowds of as many as 1,000 people.

In one of their four debates, on October 11, 1869, Perry and Greeley locked horns in Boston. It was a damp New England night as coastal cities were recovering from high tides caused by the category two hurricane, "Saxby Gale." The hurricane was named for Stephen Martin Saxby, a lieutenant in the British Royal Navy, whose published prediction of the storm had been ignored.

According to coverage in *The New York Times* the following day, Perry stressed at the debate that the lower costs of goods would increase demand and boost sales in addition to most government tax collections.

"Every nation that has outlived the folly of protection has acknowledged at length that it was a losing system for them from first to last," Perry said." We have had 11 different acts since 1861 and are already threatened with another, and what could we expect but losses from a system that professes to be wiser than nature is?"

The United States, Perry argued in Boston's Music Hall, raises less than $5 per capita by its tariff, while England raises over $4 without it.

Perry also criticized Greeley's use of the word, "protection." While it sounds good and is associated with security of property, Perry noted, a look beneath the word reveals that "restriction" describes it more justly.

Perry also cited two classes of protectionists — "those who are measurably honest and those who are measurably dishonest…"

"The unscrupulous men get a big profit on the products in which they are interested," he suggested. They besiege the Committee of Ways and Means, "organize lobbies, make combinations and extort by their display of grasping selfishness."

He quoted one "distinguished" late member of that committee: "If anything will make a man a free trader, it is to sit on this committee. There have been before us during the session just closed at least 500 men who wished us to lay on increased protective duties, with no intent in the world but to increase the price of their product, and thus rob the public."

Perry, according to the *Boston Daily Evening Transcript*, said he stood with New England and with the ultimate earlier free trader, Daniel Webster. Webster was the Massachusetts statesmen and orator who opposed the protective tariff from 1816 to 1824. "Alas, a piddling system of interference with private rights virtually prohibits your building ships and expressly prohibits your buying them," Perry said. "Shall this system last? The young men of the country, especially the educated young men, are almost unanimously against it."

Greeley was introduced by the mayor to vigorous applause, but evidently had little preparation, the newspaper reported. He immediately refuted Perry's criticism, citing the significant support he had in both hemispheres. Greeley argued that former slave owners are those who support the elimination of protective tariffs. Former slave-owning Southern Democrats, he said, sought to buy the labor in the cheapest market — Africa — before administrations invoked protective tariffs.

To the charge of special interests lobbying the House Ways and Means Committee, Greeley countered that Perry forgot that foreign manufacturers also use lobbyists.

Greeley stated that Alexander Hamilton, the nation's first Secretary of the Treasury, said that the widespread idea that tariffs caused prices to rise was erroneous. Rather, the ultimate tendency was to permanently reduce prices.

Foreign manufacturers have significantly cheaper shipping costs than, for example, US farmers shipping in return, Greeley said. Protection results in industrial diversification and creates and maintains jobs.

"…The independence, the assured greatness, the power and the wealth of this people depend on such an adaptation of our duties on imports that will insure their symmetrical development of the industry of the country," Greeley bellowed.

In 1872, Greeley, who had supported Ulysses S. Grant's presidential bid four years earlier, turned against him and ran for President as the liberal Republican candidate. With support from some Democrats, he campaigned aggressively against the Grant administration, but lost overwhelmingly. He died on November 29 — before the electoral college votes had even been counted.

Perry retired from Williams College in 1891 and acted as a consultant to the governors of Vermont, Massachusetts, New Hampshire and Connecticut before his death in 1905.

After their debates, protective tariffs, which had comprised more than 45% of federal revenue after the Civil War, had declined to 38% by 1875. Today, the United States is a free trade country, and the average tariff on imported goods is just 2%. **$**

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# Genesis of the “Big Three” Credit Rating Agencies

By Lesyk Voznyuk

The “Big Three” credit rating agencies — Moody’s, Standard and Poor’s and Fitch — were all founded on the principle that investors would pay for information that would protect them from loss. And all three first began as publishers of business information in the early 20th century, but branched out into securities rating as the business information industry developed. Economic forecasting also boomed early in the 20th century, and it was the combination of business statistics and principles of forecasting that gave birth to the credit rating business.

The origins of the credit rating agencies date to the 19th century. During the mid-1800s, railroads were the largest corporations in the United States. The railroad business was incredibly capital intensive and, as a result, the railroad companies issued securities — a wide variety of notes, bonds and hybrid debt-equity instruments — to finance the construction and maintenance of their infrastructure. Information about the health of railroad companies, particularly their financial health, was fragmented, providing an opportunity for pioneers in the field of business information and analysis.

One of the first of these was Maine lawyer Henry Varnum Poor. In 1849, Poor published the *American Railroad Journal* and followed it up with *A History of the Railroads and the Canals of the United States* in 1860. Then, with the help of his son, Poor founded the H.V. and H.W. Poor Company, which published business information for investors. In 1868, it published its highly-successful *Manual of the Railroads of the United States* and updated it annually thereafter. For a brief stint in 1890–1893, Poor also published a handbook on the securities of industrial companies. The lack of information about industrial companies provided an opportunity for future entrepreneurs as the number of publicly-held industrial companies grew.

The first of those entrepreneurs was John Moody, whose passion for transparency in business and information for investors dated back to his childhood. Moody’s father lost vast sums in the stock market in the Panics of 1873 and 1879. This experience led Moody to believe that if better information could be supplied to investors, they could be better protected from the vagaries of the financial markets.

In 1890, Moody obtained a job in one of Wall Street’s financial houses, Spencer Trask and Company. He began as an errand boy, but by 1899 he was the head of research at the firm. At the time, though Poor’s *Manual* of railroads was an established source of information, a similar source for information on the growing number of large, publicly-held industrial companies did not exist. Moody, with his passion for transparency and with an eye for business, decided to publish an equivalent of Poor’s *Manual* for industrial companies.

Eliphalet Nott Porter, a Spencer Trask colleague of Moody’s, provided the capital Moody needed, and Moody set to work soliciting pre-orders to finance the publication even before writing it. The *Manual* was completed in 1900 and sold 5,000 copies. It contained 12 sections with information about the finances and outstanding securities of various industrial firms, as well as railroads. Moody’s *Manual*, like that of Poor, was then updated annually.

It was not long before other firms entered the market. By 1904, the Poor Publishing Company added a volume covering industrial companies to its manual of railroad companies. Poor’s two-volume manual was more expensive than Moody’s single volume. However, with nearly the same format and base of coverage, it was Moody’s most direct competition.

In 1906, Luther Blake founded the Standard Statistics Bureau, which employed a different information distribution model. Unlike Moody’s comprehensive annually-updated manual, Blake’s Standard Statistics distributed, for a monthly subscription fee, news cards with facts about 100 leading companies.

Also around that time, Roger W. Babson created the Babson Statistical Organization to compile and distribute information that many brokerages laboriously collected themselves. Babson’s first product was the Babson Card System, which consisted of index cards providing descriptions of bonds offered by various

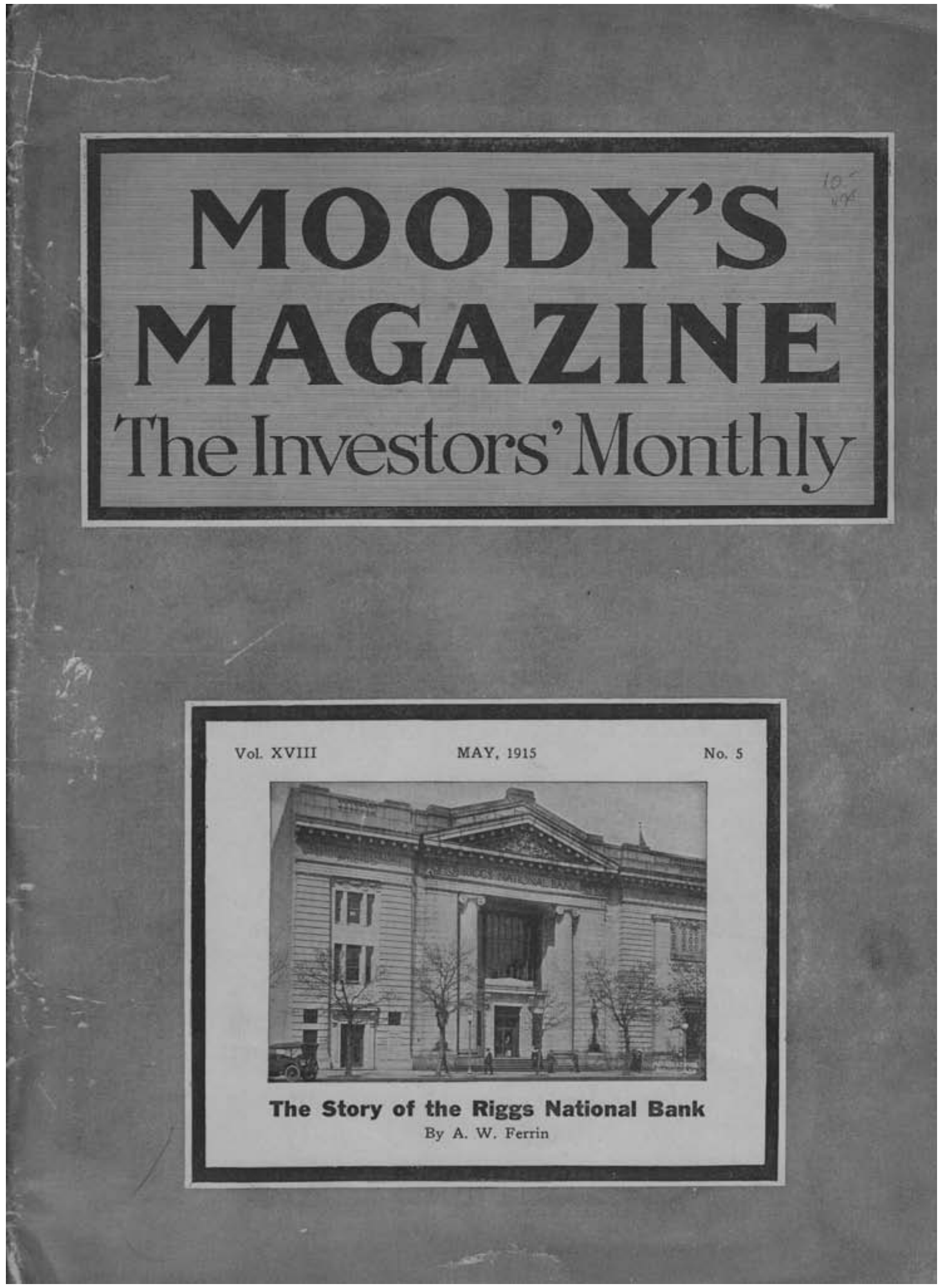
companies. This provided brokerage houses on Wall Street the option of outsourcing the compilation of information on bond offerings that had previously been done in-house.

Blake's Standard Statistics Bureau purchased the Babson Card System in 1913. That same year, John Knowles Fitch founded the Fitch Publishing Company, which also supplied business statistics to investors and the financial industry. These first publications were informative in nature. Later on, these same publishers would begin to provide advisory services, including bond ratings, to investors.

The effort to measure the creditworthiness of businesses dates back to the mid-19th century, when mercantile credit reporting agencies were founded. These agencies, while not necessarily assigning ratings to specific bond issues in the same way Moody and others would do later, nonetheless helped lay the groundwork for the establishment of the modern credit rating agencies.

The first of these was the Mercantile Credit Agency, which was founded by brothers Lewis and Arthur Tappan in 1841. Reports about the ability and reliability of merchants in repaying debts were collected by a network of correspondents and relayed back to the agency's New York offices. Rather than being published in print, reports were read to customers in a whisper at the agency's offices. In 1849, John M. Bradstreet began to distribute credit reports as well. Bradstreet chose to publish his credit reports, mailing them to customers first on loose-leaf paper and then in bound books in 1857 after moving his offices from Connecticut to New York. At the same time, Bradstreet also introduced a rating system for creditworthiness, using letters A through E. As he did with the format of Poor's manual of railroads, Moody would later integrate Bradstreet's lettered rating system into his own bond ratings.

The same entrepreneurs who noticed an untapped market for business statistics saw another market blossoming: the market for opinions about the future. Knowing how a particular railroad company had fared in the past was well and good, and knowing current information

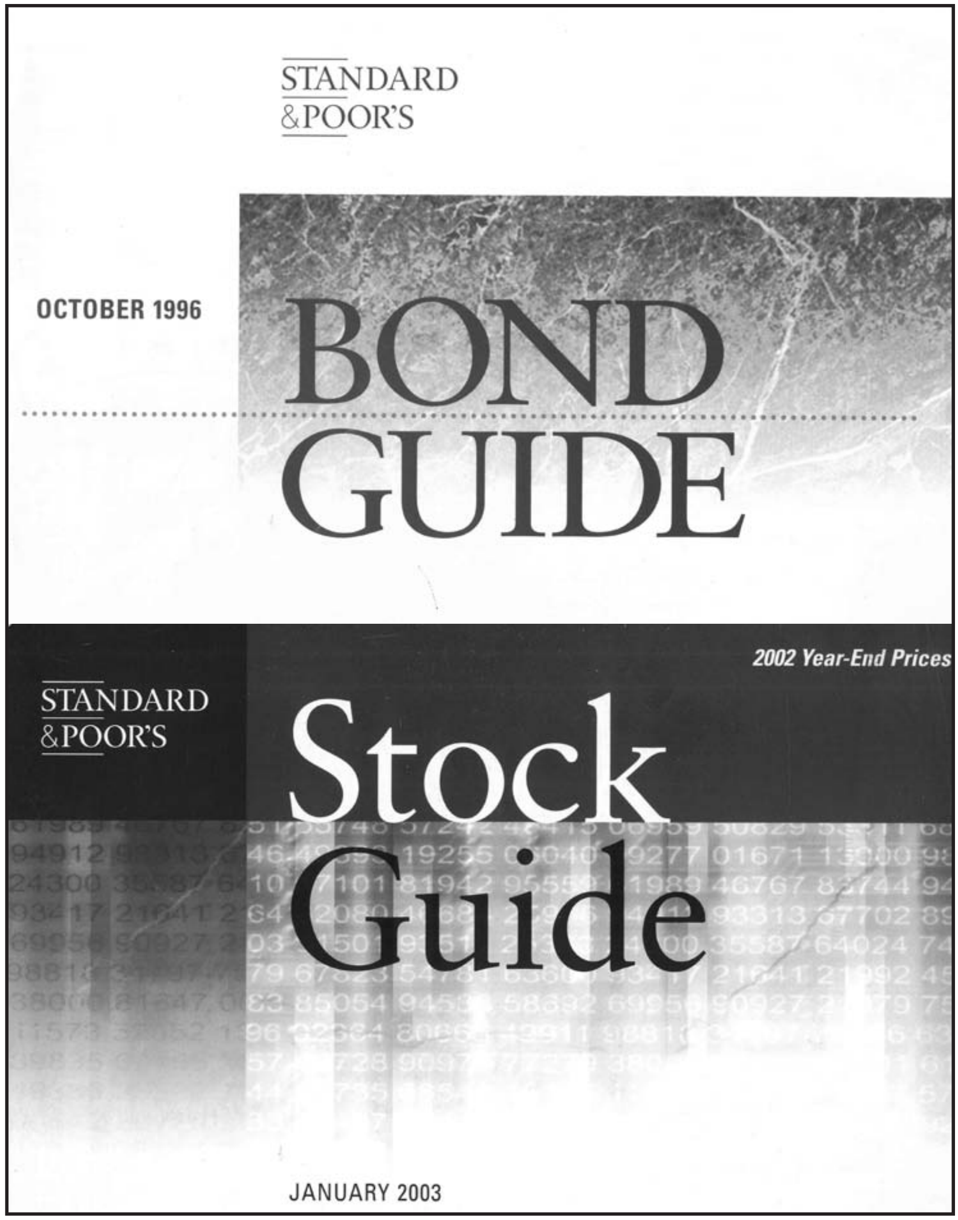



Collection of the Museum of American Finance

The May 1915 edition of *Moody's Magazine*.

was also important, but many investors wanted more. Ultimately, they were more concerned with how the securities they bought would perform in the future, rather than how they did in the last decade/year/month/week.

Thus, the stage was set for the arrival of economic forecasting. Roger Babson, creator of the Babson Card Service, was one of the first entrants into this new field. While Babson was not the first to make predictions regarding the future movements of securities prices, he was among the first to publish his predictions on a massive scale. Various methods of forecasting were prevalent at the time. Inspired by both his interest in meteorology and by the 19th-century works of Samuel Benner, who linked economic conditions to the production of pig-iron, Babson collected statistics about commodity prices, production and manufacturing, imports and exports, immigration and other miscellaneous information. He then created a "barometer" of general business activity.

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Stock and Bond Guides issued by Standard & Poor's in 1996 and 2003.

Using the idea of reversion to the mean and assuming a balance about the duration and magnitude of movements in the indicators above and below the mean, Babson released numerous publications with his predictions for business cycles. As much as he was a forecaster, Babson was first and foremost a businessman. Brilliant salesman that he was, he was able to market his publications to 20,000 subscribers by 1920. A number of other forecasters, including economists like Irving Fisher, developed their own methods of predicting movements in the economy and published their findings for the investing public as well.

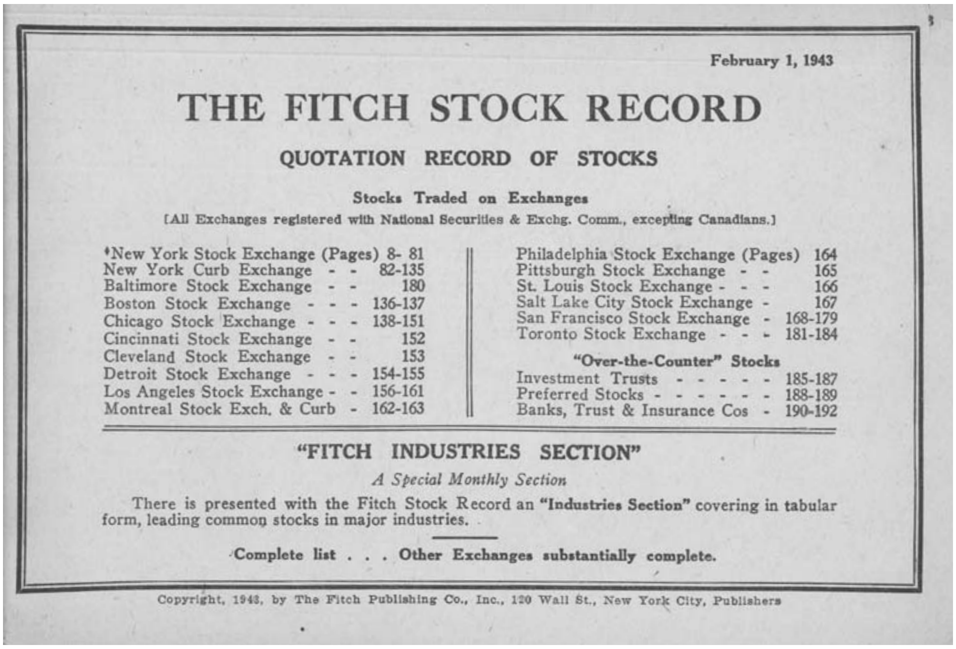
John Moody's foray into forecasting came in a rather peculiar way. As his father before him, Moody was prone to speculation. He also branched out from publishing just his *Manual* and founded the Moody Publishing Company in 1903. This company oversaw new ventures, such as a specialized financial library that researchers could access, as well as the publication of various books on economics and finance, some of which were written by Moody himself. Other business ventures, such as *Moody's Magazine*, followed soon after.

When the Panic of 1907 hit, Moody lost subscribers, and some of his other businesses produced little profit or lost money. He sold *Moody's Magazine* and, shortly thereafter, sold *Moody's Manual* to his competitor, Roger Babson, in 1908.

Despite his losses, Moody desired to re-enter the business information industry. However, he could not simply make another version of *Moody's Manual* because the agreements he signed with Babson prevented him from replicating his prior success with the same model. He needed to come up with something new, so he moved into the investment advice niche with the publication of Moody's *Weekly Review of Financial Conditions*. As was common at the time, he obtained subscriptions from his prior customers even before publishing his first edition.

In 1909, Moody began his bond rating business, with Moody's Analyses Publishing. Borrowing from the mercantile credit agencies, he used a letter code to denote the safety of various bonds, with "Aaa" being the highest and "E" being the lowest. The highest class of bonds was referred to as "investment grade," with the "B" class bonds having a "speculative tinge." Those terms are still in use today, as are the lettered ratings, with the exception of the very lowest, which have since been dropped.

What distinguished Moody's new bond ratings from his previous *Manual* of information was the use of forward-looking assessments of securities. In order to assign his ratings, Moody — aided by a massive data gathering operation — performed fundamental analysis on the underlying business in order to assess its ability to earn money to meet its future obligations. In starting his bond-rating business, Moody synthesized the collection and publication of financial statistics and information, the rating of creditworthiness similar to the credit reports of the mercantile credit agencies and the use of forecasting applied to individual firms rather than the overall economy. Indeed, even as a forecaster, Moody did not look at the economy as a unified system, but rather as a web of interconnected individual firms. Thus, while Babson and others used their methods of statistical analysis



February 1, 1943

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| | |
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| New York Curb Exchange - - | 82-135 |
| Baltimore Stock Exchange - - | 180 |
| Boston Stock Exchange - - - | 136-137 |
| Chicago Stock Exchange - - - | 138-151 |
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Opening page of the Fitch Stock Record, 1943.

to predict the future movements of prices and future conditions in the economy overall, Moody applied his methods to individual firms and bond issues.

As with his *Manual*, it wasn't long before other publishers saw the value in Moody's bond rating business and entered the market themselves. Poor's Publishing launched its bond rating service in 1922, offering ratings for corporate and municipal bonds. In 1923, Standard Statistics also joined the market, and in 1924 Fitch Publishing Company began to publish bond ratings as well. Standard Statistics and Poor's Publishing merged in 1941, forming Standard and Poor's. Thus emerged today's "Big Three" credit rating agencies.

The country's reaction to the Great Depression produced a piece of regulation that cemented the place of these three firms in the securities industry. In 1936, the Office of the Comptroller of the Currency (OCC) banned banks from holding non-investment grade securities. But since "investment grade" was a term used specifically to refer to bond ratings, this effectively required all securities to be rated if they were to be sold to institutional investors. Similar measures linking capital requirements of insurance companies to bond ratings were enacted by insurance regulators in the decades that followed. The "Big Three" have retained their place as the foremost names in bond rating ever since, but they have had their share of struggles as well.

The key problem arose from a major change in their business model. Traditionally, rating agencies had charged subscription fees to investors. However, in response to a changing marketplace in the 1970s, they began to charge issuers to have their bonds rated. This provided a solution to a very real free-rider problem exacerbated by the proliferation of inexpensive photocopying. Namely, investors who did not pay for agencies' books were able to obtain the ratings from other investors. Then, in 1975, the SEC enacted capital requirements for broker-dealers, also linking them to bond ratings.

Fearing that companies might skirt regulations by dealing with less-than-reliable rating agencies, the SEC created a new regulatory category: Nationally Recognized Statistical Rating Organization (NRSRO); that is, credit rating agencies whose ratings could be relied on for regulatory purposes. Unsurprisingly, Moody's, S&P and Fitch immediately received NRSRO designation. By 2000, although other rating agencies had been designated NRSROs, a series of mergers meant that the only ones remaining were the "Big Three."

The "issuer pays" business model has resulted in public criticism over the years, as many believe it contains an inherent conflict of interest. Rating agencies could be tempted into a "race to the bottom," inflating ratings for fear of losing business to other agencies. The NRSRO designation by the SEC does limit this sort of competition, but it also limits the incentive to improve the quality of ratings.

In addition, the "Big Three" have been criticized by some for being too slow to downgrade ratings and by others for being too slow to upgrade ratings when conditions change. Largely because of overly optimistic ratings given to mortgage-backed securities during the recent financial crisis, the Dodd-Frank Act of 2010 mandates a review of the regulatory reliance on ratings. The full effect of this and other legislation on the status of the rating agencies remains to be seen. $

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# *Belly of the Exchange*

## The Historic New York Stock Exchange Luncheon Club

On loan from LaBranche & Co.

Isidore Bonheur's bull and bear sculpture that once greeted members at the entrance of the Stock Exchange Luncheon Club has been on view at the Museum of American Finance since 2008.

**By Bart Ward**

For more than a century, the iconic NYSE trading floor on the corner of Wall and Broad Streets has been considered the center of the American financial system. A lesser-known room that existed within the walls of that historic building was the Stock Exchange Luncheon Club (SELC), which operated from June 1898 to April 2006. The Club was not officially part of the NYSE, but was a separate organization with its own president and officers, board of directors and general manager; it also maintained its own membership, separate from the Exchange.

According to Steven Wheeler, NYSE director of archives, corporate giving and education, "The Luncheon Club was a private dining club for NYSE members who could have a meal in the large elegant dining room, or have lunch delivered to their workstation on the trading floor. The Luncheon Club provided a convenient alternative to the nearby lunch counters, buffets and cafeterias in the Wall Street neighborhood."

In the foreword of Arthur Cashin's 1999 book, *A View of Wall Street From the Seventh Floor,* then Club president, Jack Dalessandro, wrote, "The survival of the Club through wars, crashes and heady times is a testament to its past leaders and membership." Ray Pellecchia, long-time NYSE vice president of communications, said, "Back in the day, the trading floor could be seen as an extended family, and the Luncheon Club was where they went to sit down together and break bread. When I joined the NYSE in 1988, the trading floor was the beating heart of the place, and the Club was perhaps the belly."

Mel Nudelman/New York Stock Exchange

Dining room of the Stock Exchange Luncheon Club, 1903.

The members of the Club were at the heart of the most dominant financial system ever created, and the elegant atmosphere reflected that. For decades, one of the Exchange's historic trading posts had been set into the entrance of the main dining room, and the famed bull and bear statue sculpted by the Frenchman, Isidore Bonheur, greeted members as well. The sculpture is currently on view at the Museum of American Finance.

The Club was like no other restaurant. According to Pellecchia, "Every morning before the bell and at lunchtime, the big, wood-paneled main room was packed with hundreds of members and their staffs. It looked very formal, with everybody in business attire and the waiters in formal uniforms, but at the same time you couldn't find a more informal place anywhere, because everyone knew everyone else and were friends and colleagues, as well as fierce competitors."

Bob Zito, former executive vice president of the Exchange, reminisced that the "staff was like family, which made the experience amazing."

Beyond the main dining room, the Club had a service desk, and the employees who worked there made a variety of arrangements including cars rides, theatre tickets, holiday events, etc. The desk even cashed checks. The Club also sported a reading room where members had access to a number of financial and non-financial newspapers and periodicals from around the world. Down the hall was a game room complete with backgammon tables and where plenty of gin rummy was played (they even printed their own gin rummy score cards). There was also the Luncheon Club lounge with a ticker tape where light lunches and drinks were served.

By the late 1990s, the Club had some 1,450 members. According to Pellecchia, "It was boisterous, and in the morning the intensity picked up as the trading day approached. Members and their staffs would huddle at the large round tables and talk about the news of the day. Specialists talked about what might impact their assigned stocks, and brokers discussed what could be expected from clients. There was a great sense of anticipation and preparedness, besides the need to get enough protein and carbohydrates to make it through the intensity of a day on the floor."

The Club was originally founded at 70 Broadway and moved to 18 Broad Street when the current NYSE building was completed in 1903. The neoclassic building, designed by architect George B. Post (1837–1913), features a classic portico, colonnades and a triangular pediment. It was also one of the first air conditioned buildings. Its sister building at 11 Wall Street was designed by Trowbridge & Livingston and built in 1922. The SELC was expanded into 11 Wall Street and thus occupied space in both buildings, which became seamless.

Tom Facchine, a NYSE executive floor governor with designated market maker KCG, said, "Personally, when I became a member of SELC there was sense of having 'matured' as a trader. In general most young traders started out as clerks or assistant traders who were not granted membership to the SELC until they became a member of the NYSE. When a clerk or assistant learned the ropes and was promoted to become a member of the NYSE, he usually also became a member of SELC. So becoming a member of SELC was the community's acceptance that you had earned your stripes to hang with the pros. Once becoming a member, I quickly noted there was always a mutual respect among the brokers young and old."

According to Zito, the Club was also the ideal place for NYSE members to promote the Exchange. "From a marketing perspective, [it was] a great way to reinforce the elegance and leadership of the brand," he said.

"For a new staffer in the press department, the Club was a great place to find members before the open — before they got so busy they could hardly speak with you," said Pellecchia. I would go down to the Club to ask a member to do an interview, or bring a reporter to the trading floor and give him a first-hand look at how the market worked."

For decades, many charitable organizations had access to SELC to raise money and promote themselves. The Club's atmosphere and location in the heart of the Financial District was a big draw for these organizations. In addition, the Club was used for holiday displays, especially during Christmas.

"It was a grand place in its time, filled with the colorful characters and larger-than-life personalities who made both the trading floor and Luncheon Club memorable places for me," said Pellecchia. "I will always feel humbled and honored to have been able to work with and get to know so many great people in these special places."

In a *New York Times* article on the closing of the Club, Peter Edmonston wrote:

> 'It was the grandest of places for people in business,' recalled Peter Dully, 64, a retired managing director at Bear Stearns and a member of the Luncheon Club for 42 years. Mr. Dully said he went to the Club for years every morning for breakfast and hung

his coat there and returned at the end of the trading day to talk shop and trade stories over a single-malt whiskey or a cold beer."

Quoting Rich Adamonis, the NYSE senior vice president of corporate communications at the time, Edmonston continued:

> The Club's board, members and staff, with the support of Exchange management, have done their utmost in recent years to maintain the viability of the Luncheon Club, which has been a prominent fixture at the Exchange for more than 100 years. It will be missed.

But perhaps Facchine sums it up best: "The SELC has a very prominent place in the history of US capitalism, and I would suspect it is due to the healthy competition and camaraderie that ran through the lineage of its members." $

*Bart Ward is CEO of the Investment Advisory firm of Ward & Company, Ltd. Since 1993 he has written the weekly Wall Street history and market-oriented column, "The Corner." He has his degree in history from UCLA.*


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# America on the Bargain Counter

*continued from page 15*

the New York Stock Exchange topped one million shares; in 1922, there were 116. In 1922, the Dow Jones Industrial Average gained 21.5% and the Dow Jones Railroad Index 15.5%. Passenger car production was up by 63%, to 1.83 million, and passenger car registrations were up by 16.2%, to 10.9 million. There was a reciprocal decline in railroad passenger service of 6.6%. As the tractor was overtaking the horse, so was the automobile displacing the passenger train.

The number of corporations reporting net income in excess of $100,000 jumped by 66.3%, to 8,864. Daily newspaper circulation was up by 5% (to 29.8 million); strong, as well, were newspaper advertising lineage and advertising rates.

There were unmistakable signs of prosperity in the patterns of American migration. In 1922, 309,556 people immigrated to the United States, which was down by 496,000, or 62%, from 1921, the year of the restrictive Quota Act. More telling of the change in economic fortunes was the drop in emigration: 198,712 persons chose to leave the United States in 1922, 19.8% fewer than in 1921.

Nominal wage rates continued to fall in 1922. Average hourly rates in manufacturing industries dropped to 49 cents an hour from 52 cents an hour in 1921, a decline of 5.8%. The stock market evidently intuited the fact that, in 1922, productivity leapt even as wage rates declined. In this year of recovery, overall manufacturing output matched the volume of 1920, while total employment was the lowest since 1915.

The result was a 20% surge in output per person, the largest ever recorded up until that time. In fact, nothing in the 20th century had come close. Business activity had slumped to one degree or another in 1904, 1908, 1911 and 1914. Increases in productivity in the years following those declensions were, respectively, 9%, 8%, 11% and 8%. The year 1922 stood alone.

What accounts for the power of the 1922 rebound? Fast-paced replenishment of depleted inventories is one reason. Easier money — lower interest rates brought about by the influx of gold and the relaxation of Federal Reserve monetary policy — is a second. The very deflation of 1920–21 is a third. For those with money to spend, the dollar bought more of nearly everything, from cars to commodities to common stocks.

"From practically all angles," judged the *Wall Street Journal* in a New Year's Day 1923 retrospective, "1922 can be recorded as the renaissance of prosperity." $

*James Grant is the founder and editor of* Grant's Interest Rate Observer, *a twice-monthly journal of the investment markets. He is also the author of five books on finance and financial history. This article has been adapted from his latest book,* The Forgotten Depression: 1921, the Crash that Cured Itself *(Simon & Schuster, 2014).*


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# TRIVIA QUIZ

By Bob Shabazian

**1.** Who was the nation's longest-serving Secretary of the Treasury?

**2.** What salary was paid to John Adams as the first Vice President of the US?

**3.** What executive action by President Franklin D. Roosevelt in 1939 gave rise to the phrase "Franks-giving?"

**4.** In which month have nine of the worst plunges (percentage-wise) of the Dow Jones Industrial Average occurred?

**5.** Who were the chairmen of the New York Stock Exchange and the American Stock Exchange at the time of the October 19, 1987 stock market crash?

**6.** What artist created the famous "Charging Bull" sculpture in Lower Manhattan?

**7.** Which two brothers once supplied automobile components to the Ford Motor Company and later formed their own automobile company?

**8.** When the states ratified the 16th amendment to the US Constitution in 1913, what action did they give the federal government authority to take?

**9.** What piece of legislation created the Federal Deposit Insurance Corporation (FDIC)?

**10.** What was the world's first billion-dollar corporation?

**1.** Albert Gallatin **2.** $5,000 **3.** He moved Thanksgiving forward by a week to lengthen the Christmas shopping season. A few years later, the idea was abandoned and Thanksgiving was established as the fourth Thursday in November. **4.** October **5.** John J. Phelan Jr. at the NYSE and Arthur Levitt, Jr. at the Amex **6.** Arturo Di Modica **7.** Horace and John Dodge **8.** The power to levy a tax on income **9.** The Banking Act of 1933 **10.** US Steel, formed in 1901 with capitalization estimated at $1.4 billion

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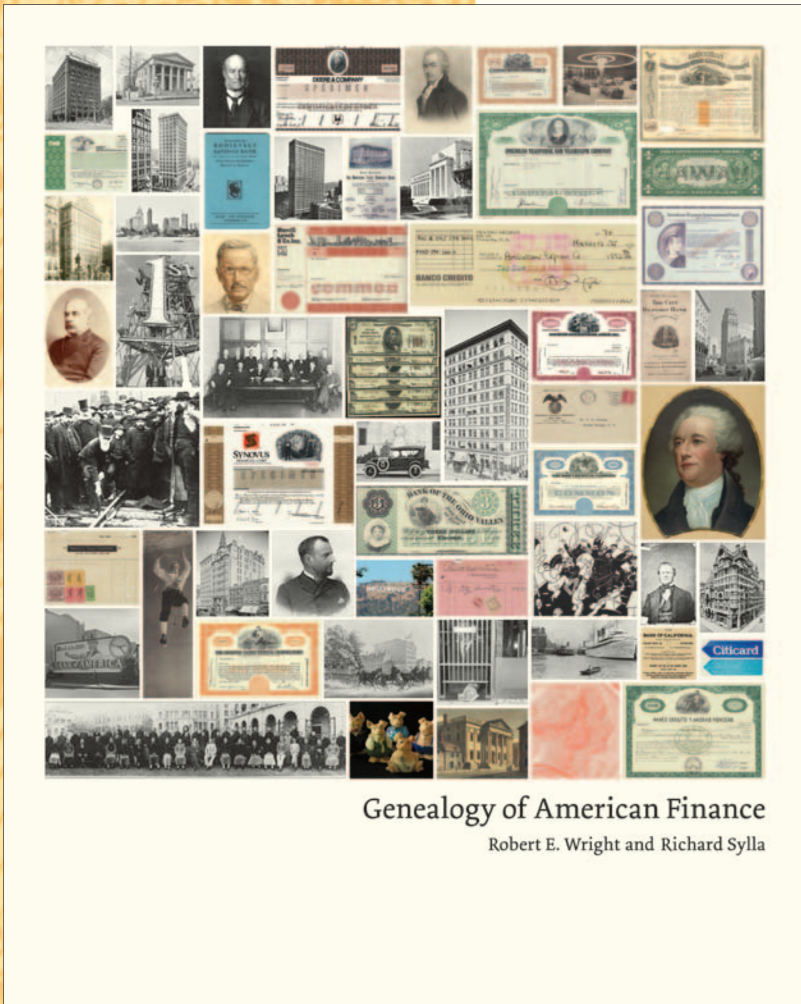


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